FISCAL CHALLENGES FACING ARAB COUNTRIES IN THE ESTABLISHMENT OF THE ARAB CUSTOMS UNION

June 2015

Abstract

The paper describes the experiences of other customs unions in tackling mechanisms and options available for the selection of a suitable Common External Tariff (CET), the establishment of mechanisms for the collection and allocation of customs revenues and for the compensation for revenue losses and presents the fiscal challenges facing Arab countries in the establishment of the Arab Customs Union (ACU). This analysis has revealed that while some Arab states may face potential tax revenue losses from ACU accession, others on the contrary may observe an improvement. The net effects at the country level depend largely on the CET chosen, the contribution of trade-related taxes to government revenues, and on countries’ diversification of indirect tax instruments. Accordingly, a careful analysis of fiscal implications of alternative CET should be undertaken at the country level to estimate potential costs and determine the appropriate compensation mechanism. The objective is to select the optimal CET which may induce the lowest costs and highest gains on fiscal, economic, and social dimensions of economic development.
1. Introduction

The economies of the Arab Customs Union (ACU) are characterized by a high degree of heterogeneity demonstrated by variations in population size, GDP, development levels, structure of trade, and dependence on government spending and diversity of their sources of revenues. Due to these disparities, member countries will experience different implications of joining the ACU. The paper aims to present the challenges that may be faced by Arab countries in case they move forward in the implementation of the ACU with a distinction between two major groups: those highly dependent on trade taxes as a source of government revenues and those that are less dependent.

Implementing a Custom Union (CU) will impact the member countries’ economies through various channels. The new tariff schedule will change domestic prices of imported goods and will, thus, affect demand for imports by consumers and supply by domestic producers of such goods. Changes in tariff rates and regional imports, together with the change in import flows, will affect customs revenue. The aggregate effects will determine whether the formation of the CU has positive or negative welfare effects. The total welfare effect of the CU implementation is the sum of three variables: change in revenue, change in consumer surplus, and change in producer surplus. To calculate the welfare effect as accurately as possible, there is a need to determine the effect of the CU formation on all consumer and producer prices, as well as the effect on all sources of government revenue.

In this specific paper, the focus is on two issues. First, the aim is to present the challenges and opportunities in terms of fiscal implications that will face most Arab countries due to the establishment of the ACU. Secondly, it will review other experiences of CUs around the world and formulate some guidelines for Arab member countries. This paper is among a series of technical papers that ESCWA is working on with the aim to formulate the most plausible options for launching the ACU with a detailed and robust impact assessment of their economic and social impacts on selected member countries.

A second technical paper will then estimate detailed economic and welfare implications from the adoption of a Common External Tariff (CET). The impact of a change in MFN tariffs on import demand is straightforward. If the tariff is lowered, import prices decline and imports expand. If MFN tariffs are increased, then the opposite effect will be realized at least in the short and medium terms. The effect of a preferential reduction in regional tariffs is less straightforward since it may not necessarily have an effect on the domestic prices of imports. If regional imports for any given tariff line are only a small fraction of total imports by a country, and thus dominated by third country imports on which the MFN tariff is applied, then the domestic price of imported goods will be determined by the market price and the MFN tariff rate. Regional tariff preferences will, therefore, not lead to a decrease in import prices or a change in import demand. If, on the other hand, imports of certain tariff items are predominately sourced from CU partners, the regional tariff preference will lead to a reduction in the import price for such goods and a demand expansion. Thus, the impact of forming a CU on customs revenue is in general undetermined; it depends on a country’s tariff levels prior to joining a CU, the CET applied, import demand elasticities, and export supply elasticities in the CU member states. Hence, two effects can be distinguished; (1) the effect on customs duty revenue from the change in tariff rates, and (2) the effect on domestic tax receipts (excises and VAT) collected on imports.

The issue is very important in the Arab region in the context of creating a CU, for many reasons. The most important among them are the following:

- Tariff dispersion in the Arab region is high. Some countries are applying low national tariffs (around 5%) while others are applying high rates (30%);
- Tax policies are very heterogeneous in the region with some countries only applying tariffs on imports while others apply VAT and excise tax;
- Tariffs on imports highly contribute to budget revenues in some countries while, in others, the contribution is small;
- The impact of adopting alternative CETs on public finances is expected to be challenging for some countries while in others the effects will be almost nonexistent;
- Compensation measures should be implemented for countries that will experience fiscal loses, at least in the medium run, otherwise they will be negatively affected;
- The compensation mechanisms are a key determinant of the success of any custom union.

In addition, most if not all countries that may be negatively affected from the implementation of the ACU are facing particular economic and social tensions either as result of the political changes that occurred since 2011 (Tunisia, Yemen, and Egypt), or from the economic slowdown that can be explained by political tensions in neighboring countries (this is the case of Jordan and Lebanon). Thus, the ACU comes at a time when public finances in most Arab non-oil economies such as Tunisia and Egypt are facing increasing challenges where deficits jumped from less than 3% before 2011 to more than 8% currently. Accordingly, implementing the ACU without a detailed estimation of fiscal losses and identification of compensation mechanisms will certainly accentuate already high pressures on public finances.

This paper will present in section II the general features of Arab countries members of GAFTA and potential members of the ACU and will highlight the disparities between them namely in their dependence on customs revenues. Section III highlights the fiscal challenges of joining the ACU while Section IV presents the issues at hand that Arab countries must deal with in the establishment of the ACU and which relate to the selection of a suitable CET, the establishment of mechanisms for the collection and allocation of customs revenues and for the compensation of revenue losses.

**II. Background on GAFTA’s member countries**

1) General features of the Arab countries members of GAFTA

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Algeria</td>
<td>5,361</td>
<td>67.8</td>
<td>69.79</td>
</tr>
<tr>
<td>Bahrain</td>
<td>24,613</td>
<td>128.1 (2011)</td>
<td>80.65</td>
</tr>
<tr>
<td>Egypt</td>
<td>3,314</td>
<td>46</td>
<td>7.99</td>
</tr>
<tr>
<td>Iraq</td>
<td>6,670</td>
<td>74.9</td>
<td>98.52</td>
</tr>
<tr>
<td>Jordan</td>
<td>5,214</td>
<td>116.4</td>
<td></td>
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<td>Kuwait</td>
<td>56,367 (2012)</td>
<td>92.2 (2011)</td>
<td>94.49</td>
</tr>
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<td>Lebanon</td>
<td>9,928</td>
<td>143</td>
<td></td>
</tr>
<tr>
<td>Libya</td>
<td>12,167</td>
<td>96.1 (2009)</td>
<td>94.15</td>
</tr>
<tr>
<td>Morocco</td>
<td>3,109</td>
<td>81.6</td>
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<tr>
<td>Oman</td>
<td>22,181</td>
<td>108.9 (2011)</td>
<td>72.53</td>
</tr>
<tr>
<td>Qatar</td>
<td>93,352</td>
<td>87.9 (2011)</td>
<td>35.76</td>
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<tr>
<td>Saudi Arabia</td>
<td>25,852</td>
<td>81.3</td>
<td></td>
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<tr>
<td>Sudan</td>
<td>1,753</td>
<td>30.4</td>
<td>23.26</td>
</tr>
<tr>
<td>Tunisia</td>
<td>4,329</td>
<td>104.2</td>
<td>0.65</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>41,692 (2012)</td>
<td>152.6 (2011)</td>
<td>75.32</td>
</tr>
<tr>
<td>West Bank and Gaza</td>
<td>2,530 (2012)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yemen</td>
<td>1,473</td>
<td>62.4</td>
<td>67.71</td>
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</table>

*Data on Population and GDP from World Bank*
*Data on Surface Area from UN Statistics Division – Demographic Yearbook 2012*
Wide differences in the level of economic development, as measured by GDP per capita and population size are evident in the Arab region. As can be observed from Table 1, the oil exporting countries have a high dependence on oil revenues as a source of public revenues, which explains their non-reliance on taxes as a source of revenue. On the other hand, countries such as Tunisia and Morocco depend heavily on tax revenues and therefore, these vast differences in public policy pose challenges to the formation of a CU where harmonization of some fiscal policies and the implementation of a common external tariff are required.

2) Intra-regional trade flows

Some of the main justifications or motivations behind establishing a CU are to reduce trade costs among members and to harmonize external trade policy for various development reasons such as the creation of a large internal market, preferences for products produced in the region, etc... Thus, we may expect from the implementation of a CU an increase in intra-regional trade 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.

However, in a region characterized by low levels of intra-Arab trade, low trade complementarity and limited diversification, the expected benefits from the establishment of the 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 (Evans, et al., 2006).

As can be seen in Table 2, Arab trade has been growing steadily since 2002. The highest rate of intra-exports was achieved in 2009 while the highest rate of intra-Arab imports was observed in 2011. Intra-Arab exports declined in 2011 by 1.8 percent compared to 2010, while intra-Arab imports increased by 0.9 percent between the two years. The political changes and internal conflicts affecting many countries played a major role in these performances.

Imports from Arab countries have been stable in the last decade, ranging between 10.7 percent as the lowest share recorded in 2003 to 13.4 percent as the highest recorded share in 2012 (Arab Monetary Fund, 2013). Conversely, imports from the European Union have been declining steadily over the last ten years, from 44.6 percent in 2002 to 26.5 percent in 2012, while imports from Asia have increased by 64.11 percent over the last decade to reach 34.3 percent in 2012 (Arab Monetary Fund, 2013).

Arab exports to the European Union have also decreased over time from 25.8 percent in 2002 to 13.5 percent in 2012, demonstrating an overall decreasing trend in trade between the Arab region and the European Union as a result of declining demand in the EU against faster growing economies in Asia. The Arab countries have been steadily increasing their trade to Asia and shifting from Japan to increased trade with China and other Asian partners. Exports to Asia grew from 25.6 percent in 2002 to reach 42.9 percent in 2012, an increase of approximately 68 percent. Exports to other Arab countries have been steady and reached 8.7 percent in 2012, with the highest share recorded at 10.3 percent in 2009 (Arab Monetary Fund, 2013).
Only a few Arab countries export heavily to other Arab countries, namely Jordan (48.6%), Lebanon (38.9%), Sudan (35.1%) and Egypt (31.8%) as demonstrated by the countries’ share of inter Arab exports to total Arab exports in 2012. Conversely, the UAE, Algeria, Iraq, Qatar, Kuwait, Libya, Morocco, and Yemen export mostly to non Arab partners (Arab Monetary Fund, 2013).

With respect to inter Arab imports as a percentage of total Arab imports, the following countries have a high share: Jordan (35.7%), Bahrain (35.2), Sudan (30.6%), Oman (30.2%), and Yemen (30.8%). On the other hand, the UAE, Tunisia, Algeria, Saudi Arabia, Libya and Egypt do not rely on Arab countries for their imports.

In general, inter-Arab trade continues to be mostly concentrated in dealings between neighboring Arab countries. Thus, in 2012, the bulk of inter-Arab exports of Jordan were directed towards Iraq and Saudi Arabia with a share of 31.06% and 22.7% respectively of their total exports to Arab countries. Tunisia exported mainly to Libya with a share of 45.53% and Algeria with a share of 26.65% while the bulk of inter-Arab exports of Sudan were concentrated in UAE with a share of 80.14%.

On the import side, the geographical location of a country also plays a role in determining its inter-Arab trade partners. Therefore, the larger part of inter-Arab imports of Jordan were from Saudi Arabia with a share of 65.95%, while 47.99% of Yemen’s inter-Arab imports were from the United Arab Emirates and 40% of Tunisia’s inter-Arab imports were from Libya and Algeria with a share of 14.69% and 45.78% respectively. Lebanon is considered to be the most diversified importer among Arab countries as 74.01% of its inter Arab imports come almost equally from the United Arab Emirates, Saudi Arabia, Kuwait and Egypt.

Traditionally, inter Arab trade has been focused primarily on manufactured products, minerals and fuels, followed by agricultural products. Inter Arab exports of manufactured products reached 47.3% in 2012, followed by minerals and fuels at 27.1% and agricultural products at 18.9%. On the imports side, manufactured products received a share of 44.1% of inter-Arab imports in 2012, while minerals and fuels reached 35.3% and agricultural products were at 15.7% (Arab Monetary Fund, 2013).

3) Dependence on Customs Revenues

Table 3: International Trade Taxes as a share of Total Government Revenue Excluding grants (%) – Subgroup GAFTA countries

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</tr>
</thead>
<tbody>
<tr>
<td>Emirates</td>
<td>2.39</td>
<td>2.69</td>
<td>2.91</td>
<td>3.06</td>
<td>3.21</td>
<td>2.68</td>
<td>2.22</td>
<td>3.51</td>
<td>N/A</td>
<td>4.24</td>
<td>2.87</td>
<td>2.64</td>
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<tr>
<td>Bahrain</td>
<td>5.25</td>
<td>5.88</td>
<td>4.76</td>
<td>4.44</td>
<td>4.46</td>
<td>3.62</td>
<td>3.81</td>
<td>4.00</td>
<td>3.74</td>
<td>4.94</td>
<td>4.70</td>
<td>3.75</td>
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<tr>
<td>Tunisia</td>
<td>10.68</td>
<td>10.33</td>
<td>8.83</td>
<td>7.62</td>
<td>7.29</td>
<td>6.70</td>
<td>6.27</td>
<td>6.14</td>
<td>5.98</td>
<td>5.85</td>
<td>6.20</td>
<td>5.32</td>
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<tr>
<td>Saudi Arabia</td>
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<td></td>
<td></td>
<td>0.61</td>
<td>1.28</td>
<td>1.20</td>
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<tr>
<td>Iraq</td>
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<td></td>
<td>0.44</td>
<td>0.83</td>
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<tr>
<td>Oman</td>
<td>2.01</td>
<td>2.32</td>
<td>1.99</td>
<td>1.97</td>
<td>1.76</td>
<td>1.97</td>
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<td>2.70</td>
<td>2.87</td>
<td>2.13</td>
<td>2.12</td>
<td>1.50</td>
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<td>Qatar</td>
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<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Kuwait</td>
<td>1.45</td>
<td>1.19</td>
<td>1.61</td>
<td>1.62</td>
<td>2.12</td>
<td>1.85</td>
<td>1.13</td>
<td>1.18</td>
<td>1.02</td>
<td>1.08</td>
<td>1.01</td>
<td>0.74</td>
</tr>
<tr>
<td>Libya</td>
<td></td>
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<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td>0.99</td>
<td>0.62</td>
</tr>
<tr>
<td>Egypt</td>
<td>12.62</td>
<td>12.32</td>
<td>12.39</td>
<td>135.9</td>
<td>3.92</td>
<td>7.17</td>
<td>6.48</td>
<td>5.88</td>
<td>6.37</td>
<td>5.13</td>
<td>5.57</td>
<td>5.27</td>
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<tr>
<td>Morocco</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>4.81</td>
</tr>
<tr>
<td>Yemen</td>
<td>5.14</td>
<td>6.22</td>
<td>6.61</td>
<td>6.33</td>
<td>6.48</td>
<td>4.69</td>
<td>2.48</td>
<td>3.11</td>
<td>2.48</td>
<td>4.53</td>
<td>3.77</td>
<td>3.32</td>
</tr>
</tbody>
</table>

Source: Arab Monetary Fund, Economic Statistics Bulletin for Arab countries for 2013 issue (33)
Table 3 presents the dependence of countries on international trade taxes as a source of total government revenue. The data allows us to categorize the region into two general groups: countries that have a high dependence on trade taxes and countries that have a low dependence on trade taxes. Lebanon and Sudan fall into the former category; international trade taxes accounted for 22.09% and 10.36% of total government revenue in 2010, respectively. Comparatively, the GCC has a very low dependence on trade taxes. Jordan, Iraq, Libya, Egypt, Morocco and Yemen all have a low dependence on trade taxes as a source of government revenue.

However, the concept “international trade tax” does not have a clear definition, which explains the disparities we see. The disparities are attributed to the differing trade tax systems and tools implemented by the different countries. The GCC, for example, has only implemented tariffs or customs duties; tariffs, therefore, are their only means of extracting revenue from imports. Alternatively, Lebanon’s high dependence 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. Along with customs duties, Lebanon collects a 10% VAT on imports, and excise duties are collected on cars, tobacco, gasoline and alcoholic and nonalcoholic beverages. The dependence on non-tariff taxes is high; excise duties form 65% of total taxes on international trade (Ministry of Finance, 2012). Similarly, Jordan, Sudan and Egypt have alternative means of deriving revenue from imports beyond tariffs: Jordan has a General Sales Tax of 16% on the supply and import of taxable goods and special taxes ranging from 6-102% on certain categories of goods and services. Sudan has a VAT of 17%. Egypt’s tax on goods and services is applied to imported goods, forming around 12% of total tax revenue gathered by the State.

The case of Tunisia is worth mentioning as the differing definition of what constitutes international trade taxes either categorizes it as a country that is definitively highly dependent on trade taxes or one that is not. As seen in Table 3, tariffs only account for around 6% of total government revenue; dependence on tariffs fell from 10.68% in 2000 to 5.32% in 2011. However, Tunisia has a standard VAT rate of 18% and excise taxes contribute almost 10% of total taxes. When indirect taxes on imports are included in the definition of international trade tax, international trade tax as a percentage of total revenue rises to over 20%\(^1\).

These countries, countries with taxes on imports beyond just tariffs, will more easily be able to compensate losses resulting from accession to the ACU and adoption of a low CET. Tunisia, Lebanon, Jordan, Sudan and Egypt have VATs, excise duties and other taxes on imports. As a result, they will fare better than countries that depend entirely and solely on tariffs to attain revenue from imports such as Yemen. The fiscal implications of the ACU are discussed in more detail in the following section.

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\(^1\) Calculated from IMF Article IV data. Indirect taxes on imports are defined as VAT on imports, Excise on imports and other taxes on imports.
Table 4: Table of Customs Tariffs imposed by Arab countries

<table>
<thead>
<tr>
<th></th>
<th>Simple Average 2012</th>
<th>Trade weighted average 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Bound</td>
<td>MFN applied</td>
</tr>
<tr>
<td>Jordan</td>
<td>16.3</td>
<td>10.9</td>
</tr>
<tr>
<td>Emirates</td>
<td>14.3</td>
<td>4.7</td>
</tr>
<tr>
<td>Bahrain</td>
<td>34.4</td>
<td>5</td>
</tr>
<tr>
<td>Tunisia</td>
<td>57.9</td>
<td>15.5</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>11.3</td>
<td>5.1</td>
</tr>
<tr>
<td>Sudan</td>
<td></td>
<td>21.2</td>
</tr>
<tr>
<td>Oman</td>
<td>13.7</td>
<td>4.7</td>
</tr>
<tr>
<td>Qatar</td>
<td>15.9</td>
<td>4.7</td>
</tr>
<tr>
<td>Kuwait</td>
<td>97.2</td>
<td>4.7</td>
</tr>
<tr>
<td>Lebanon</td>
<td></td>
<td>6.3 (2010)</td>
</tr>
<tr>
<td>Egypt</td>
<td>36.7</td>
<td>16.8</td>
</tr>
<tr>
<td>Morocco</td>
<td>41.3</td>
<td>12.9</td>
</tr>
<tr>
<td>Yemen</td>
<td>21.1</td>
<td>7.5</td>
</tr>
</tbody>
</table>

Source: World Trade Organization, Trade Profiles 2013

Table 4 presents the simple average bound, simple average MFN applied and trade weighted average rates for the countries of the region. The bound rate represents the highest customs duties rate a country can apply, a rate that is negotiated upon membership to the World Trade Organization (WTO) and is difficult to raise once established. Libya, Iraq and Lebanon are not members of the WTO and, as a result, do not have bound rates. However, the data is still relevant to the analysis. As most countries are members, any CET agreed upon by the ACU will have to adhere to the agreements the member nations have with the WTO. Saudi Arabia’s bound rate of 11.3% represents the highest CET that the proposed ACU could impose while allowing all member countries to honor their commitments to the WTO. A CET higher than 11.3% would require Saudi Arabia to renegotiate its agreement with the WTO.

With the exception of the GCC countries, Lebanon and Yemen, any CET lower than 11.3% could prove problematic for member countries. Currently, Tunisia, Sudan, Egypt and Morocco have simple average applied MFN rates of 15.5%, 21.1%, 14.2%, 16.8% and 12.9%, respectively. Jordan currently has a rate of 10.9% and therefore has a range, albeit a narrow one, within which it would be unaffected by the 11.3% ceiling.

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2 As defined by the WTO: simple average final bound is the “simple average of final bound duties excluding unbound tariff lines”; simple average MFN applied is the “simple average of MFN applied duties”.

3 As defined and calculated by the WTO: trade weighted average is the “HS six-digit MFN tariff averages weighted with HS six-digit import flows for traded national tariff lines”
III. Fiscal challenges of joining the ACU for member countries

The fiscal impact that joining the ACU will have on its member states depends to a large extent on the dependence of each country on customs revenues for total government revenues, the other indirect taxes on imports, and the weight of intra-regional trade. Indeed, in adopting zero intra-Arab tariffs and a common external tariff (CET), pressure may be placed on fiscal revenues emanating from trade-related taxes. This analysis will present implications for two general groups of Arab economies – those for which trade taxes account for a significant proportion of total government revenue, and those for which trade taxes do not contribute largely to overall revenue.

1) Countries with high dependence on trade taxes

As indicated in Table 3 above, state revenues of both Lebanon and Sudan depend to a large extent on taxes on trade. When incorporating indirect taxes on trade, through VAT and excises, trade taxes account for a high level of revenue in Tunisia. High dependence on trade taxes implies a greater potential loss from accession to the ACU, as compared with other Arab States. However, these countries also have alternative revenue schemes and other attributes which may mitigate against any adverse effects. These country-specific attributes are as follows:

In 2010, Lebanon had a relatively low simple average MFN applied tariff rate of 6.3%, and imports from countries considering joining the ACU formed only around 12% of the country’s total imports. However, taxes from international trade constitute a large portion of government revenue, and this has in fact increased in recent years, from 14.3% in 2007 to 26.2% in 2011.

Fiscal tools that Lebanon has already implemented should be able to mitigate losses resulting from accession to the ACU. The country has a 10% VAT and a corporate tax system. Furthermore, taxes on international trade are not solely derived from tariffs and custom duties; 65% of total taxes on international trade are excise duties collected on cars, tobacco, gasoline and alcoholic and non-alcoholic beverages (Ministry of Finance, 2012).

At present, Sudan enjoys an average tariff of over 20%, the highest amongst countries examined here. Additionally, over the last ten years, taxes on trade have accounted for between 7 and 15% of government revenue, relatively larger than many countries in the region. 38.9% of Sudan’s exports flow to other Arab states, and 30.6% of imports originate in other Arab states. These traits of Sudan’s fiscal sources and trade balance indicate that there are potential losses from accession to ACU. Indeed, trade taxes represent a higher proportion of revenue than many partner countries.

However, Sudan has several tax instruments at its disposal which will not only mitigate the fiscal impact of the ACU, but serve to build government revenues further. The country has a comparatively high VAT of 17% on most goods, and a corporate income tax of 15%, amongst other measures, providing a strong base which can be expanded upon for enhanced revenue collection.

Tunisia has a relatively high average tariff of 15.5%. Its level of imports from Arab economies is very low, at 8.8% of total imports. While trade taxes only directly account for just over 5% of government revenue, when indirect taxes, excises and VAT on imports are taken into account, this figure rises to over 20%. Tunisia’s diversified tax portfolio, including domestic VAT, indirect taxes, corporate and personal income taxes, provide already-existing fiscal tools to recuperate lost tariff revenue.

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4 Based on IMF Article IV data.
2) **Countries with low dependence on trade taxes**

For the countries with low dependence on trade taxes, there will naturally be fewer negative fiscal implications of accession to the ACU. However, it is important to note that for many of these countries, trade taxes still account for a large percentage of total tax revenue, implying that while non-tax sources dominate government revenue, trade taxes are still a significant contributor amongst sources of taxation.

As of 2012, Egypt had an average tariff level of 16.8%, higher than the tariffs of most Arab States. While nearly a third of Egypt's exports flow to Arab countries, its imports from Arab economies, at 12.7% of total imports, are relatively low. Furthermore, the country’s taxes on trade contributed only 5.3% of total government revenue as of 2011.

In this regard, accession to the ACU has two implications for Egypt. On the one hand, a relatively lower CET will place negative pressure on State revenue from trade. Egypt earns greater customs fees from higher value-added imports (MoF, 2009), and such manufactured, diversified goods would now earn fewer duties.\(^5\)

However, as total trade taxes account for a relatively small proportion of government revenue, the fiscal impact of ACU accession may be low. Egypt’s fiscal adjustment to the ACU will be further 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 bringing in of new revenue sources (MoF, Egyptian Economic Monitor, December 2010). Corporate and personal income taxes between 20-35%, as well as a 10% sales tax, are providing a steady revenue source for the government, while the planned VAT will assist in mitigating fiscal effects of the ACU, and in streamlining means of indirect taxation.

As of 2012, Jordan had an average tariff of 10.9%, comparable to the average rate for the GAFTA region. Dependence on taxes on international trade for government revenue has decreased in the last decade, halving from 14.51% in 2001 to 6.91% in 2011. However, Jordan depends on intra-Arab trade; imports from the GAFTA region form approximately 30% of Jordan’s total imports.

The potential loss of revenue from tariffs can be mitigated as Jordan already has other tax instruments in place. The country has a relatively high Goods and Sales Tax of 16% and high special taxes on specified goods i.e. 100% on cigarettes and 180% on alcohol. Additionally, Jordan has a progressive corporate income tax ranging from 14-30% and a progressive personal income tax. These could potentially be expanded to cover a larger tax base, with the former covering currently-exempt financial institutions, and the latter expanded to cover foreigners employed in the country.

Yemen has a tariff rate of 7.5%, which is comparatively low as opposed to those of other GAFTA countries, excluding the Gulf Cooperation Council (GCC). The country relies heavily on intra-Arab trade, with approximately one third of total imports originating from those Arab countries seeking to join the ACU. However, taxes on international trade only contributed to 3.3% of government revenue in 2011. As a result, there are few losses anticipated from joining the ACU. Yemen already has in place alternative methods to raise government revenue in the form of a progressive income tax system, with rates ranging from 10-20% and a general sales tax of 5%. The country does have a high dependence on decreasing oil revenue, however, and therefore other fiscal tools should be explored such as a VAT and excise taxes.

Countries of the GCC have similar average tariffs of 4.7%, duty exemptions for member states, and trade taxes as a small proportion of government revenue, implying that an expanded CU would reflect already-existing trade characteristics of its member states, with limited negative impact. The implications for some GCC members are detailed as follows:

\(^5\) Note: this issue is common amongst most potential ACU members.
For UAE, intra-Arab trade stands at 6% of exports and 7% of imports, and revenue flows from trade duties represent only 2.6% of government revenue as of 2011. However, trade taxes do represent nearly half of all tax revenues as of 2011, indicating that alternative fiscal tools can be drawn upon to enhance UAE’s abilities to generate revenues. UAE does not have VAT, taxes on profits, incomes, capital gains, or remittances. In addition to considering such tax tools, integration will also present fiscal opportunities for UAE, for example through the proposed 5% GCC VAT.

For Kuwait, exports to other Arab countries represent only 3.5% of total exports, and trade taxes represented less than 1% of government revenue as of 2011. Given that trade taxes represented over 60% of total tax revenue in 2011, alternative fiscal tools may also be explored. For example, the country has a 15% corporate income tax on foreign firms. This tool has potential to be expanded and shifted to cover domestic firms and consumption as well. The country has also been considering the introduction of VAT.

Oman trades extensively with the Arab region, as 30.2% of its imports are from Arab countries. Despite trade taxes accounting for as much as a quarter of tax revenue, incomes from these have remained at below 3% of government revenue for the past ten years. Thus there stand to be no significant losses in revenue from ACU accession. The VAT under consideration and the 12% corporate income tax, both provide alternative sources of revenue to the potential fall in trade taxes as a proportion of total tax revenue.

### IV. Options for establishing a Custom Union and challenges for the Arab Customs Union

1) **Economic and Political Justifications of the creation of a Customs Union**

There are five different forms of regional economic integration, namely:

- Preferential Trade Agreements: An agreement between two or more countries to lower tariffs and other trade barriers on goods and services from member countries

- Free Trade Area: An agreement between two or more countries to eliminate tariffs completely on goods and services from members. The countries, however, retain their own external tariffs on imports from countries outside the FTA.

- Customs Union: The GATT Article XXIV:8(a) defines a CU as a single customs territory substituting for two or more customs territories and having two characteristics: (a) duties are eliminated on substantially all trade between the constituent territories, and (b) substantially the same duties are applied by each member to trade with nonmembers.

- Common Market: A CU which also allows the free movement of capital and labor among member countries.

- Economic Union: A Common Market in which members have agreed on unified monetary and fiscal policies as well as a common currency.

There are many reasons for choosing a CU over maintaining a Free Trade Area, including economic and political ones. The primary effect of a CU is to expand trade among members at the expense of trade with third countries, thereby contributing to substantial economic gains for member countries. According to the 1988 Cecchini Report prepared for the Commission of European Communities on the gains expected as a result of the ‘1992’ programme for unifying the European Community's internal market, the expected effect of the creation of the European Single Market was an expanded economic activity by more than 6 percent of the EU economy.

The expected expansion of intra-regional trade can either have trade creation (more efficient suppliers in member countries replace domestic suppliers of goods) or trade diversion (more efficient third party...
suppliers are replaced by less efficient suppliers in partner countries) effects. According to Jacob Viner’s analysis in 1950, when trade diversion is more important than trade creation, CUs tend to be welfare reducing. The degree of trade diversion is often affected by the levels of common external protection agreed upon by the CU.

Notwithstanding the level of external protection, a CU acts like a large single market permitting member countries to combine their market size and increase their market power. On one hand, this can generate economies of scale, translating into lower business costs, greater benefits for consumers and enhanced competitiveness of member countries. On the other, CUs may also create pressure for more protectionism and member countries may decide to implement a high CET in order to improve their terms of trade as demonstrated by Kennan and Riezman (1990) and Krugman (1990). The CU member countries may, as part of a jointly set trade policy, lower demand on a specific imported product by charging a high CET, thereby causing a decrease in its price (Andriamananjara, 2011).

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

The CU is also perceived as the prerequisite for the establishment of a political union or, at least, some deeper form of economic integration, such as a common market. They are often pursued by countries interested in attaining some political objectives such as security or democracy. For example, in the case of the EU, Robert Schuman, French Foreign Minister and EU co-founder, stated in May 1950 in the Schuman Declaration which proposed the creation of the European Coal and Steel Community “the solidarity in coal and steel production thus established will make it plain that any war between France and Germany becomes not merely unthinkable, but materially impossible”.

In MERCOSUR’s case, Argentina and Brazil’s motives for forming a Common Market were to reduce tensions between them, resolve security problems and strengthen their fragile democracies. The creation of MERCOSUR in 1991 reinforced this process and bound smaller neighbors to it as they realized that they had little choice but to join (Schiff, 2000). In the case of the Caribbean Community (CARICOM) which contains both more or less developed countries, member countries were interested in forming a CU to pool their market power, coordinate their trade policies and combine their efforts to negotiate with the rest of the world. This high degree of coordination enables an environment of trust among countries which may decrease the level of conflict, as has been the case with the European Union. Furthermore, if CU members negotiate effectively as a bloc, non-members tend to be more conciliatory and CU members will be able to affect the outcome of the negotiations in their favor.

Another reason for creating a CU is to avoid trade deflection while facilitating higher trade levels among member countries. Trade deflection is an effect of goods being shipped from outside the Free Trade Area to a low tariff country and then trans-shipped tariff-free to a high-tariff country. This situation effectively reduces the tariff of every FTA member to that of the lowest and could cause friction among member countries. The application of a CET in a fully implemented CU eliminates the potential for trade deflection (Andriamananjara, 2011).

The establishment of a CU 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. According to Winters (1996) and Panagariya and Findlay (1996), lobbying pressure might be diluted as it will be too costly to lobby decision-makers in a large number of member countries with at times differing views. Furthermore, the returns to lobbying activities are less under a CU as compared to an FTA as the lobbied tariff protection rate becomes available to all members. Due to the high cost and low returns of lobbying, there could also be a free-rider problem in lobbying with all lobbying activities taking place in only one country. This could lead to reduced levels of
external protection, unless the opposite reaction occurs and lobby groups decide to pool their resources and cooperate in order to influence a common sector’s trade policy and common external tariff rate.

2) **Common External Tariff:**

A Common External Tariff (CET) is a basic feature of the CU as a form of economic integration. It is a common tariff structure that all member countries agree to adopt in trade with third countries instead of their own individual tariffs. Imports to the CU only have to clear customs once and can then move freely within the CU area.

The choice of an appropriate and agreed upon CET is an important element to any successful CU. Economic theory indicates that trade creation in a CU is likely to dominate when the common external tariff is low and when there are unexploited potential complementarities between partners, creating opportunities for specialization and increased trade (Evans, et al., 2006). However, the experience of CUs in force has demonstrated that negotiations among 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 Common External Tariff, as well as mechanisms for the collection and distribution of customs revenues and the compensation for the loss of revenues.

The difficulties of agreeing on a common external tariff have sometimes led to an imperfect CU which includes country or sector specific exceptions and sensitive lists. Member countries of CARICOM are allowed national derogations in addition to tariff reductions and suspensions. The CET in MERCOSUR does not cover all sectors. Initially, the ANDEAN Community’s CET which was adopted in 1995 was not applied by Peru as the government applied and managed its national tariff with complete autonomy. However, the ANDEAN Community then decided to perfect the CU in order to move ahead in forming a Common Market and to maintain a joint position in international trade negotiations. A new CET was approved and adopted in October 2002 and was applied by all member countries.

a) **Choice of a Common External Tariff**

The optimal tariff is one that improves a country or a region’s overall well-being to the extent that any welfare improvement should exceed the customs revenue losses incurred by the member countries.

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 structure is the design of the various tariffs according to their position in the production process, in order to achieve domestic competitiveness. This renders the structure difficult to design and implement amidst conflicting lobbying interests which put pressure on governments to make tariff adjustments. On the other hand, a uniform tariff structure is a uniform tariff that is applied to all goods equally. This structure is easier to design and implement, is more transparent and reduces the incentive to lobby for protection (Lord, 2008).

Another important factor that affects the selection of the CET is the role asymmetric CUs members play. Research has shown that core CUs may exhibit “super-delegation” as well as “partial delegation” of tariff-setting authority. Furthermore, when a CU is established, it is typically the member which is relatively well-endowed with its export good or has the relatively inelastic preferences that assumes greatest responsibility for external tariff choice (Melatos & Woodland, 2008).

There are several types of CETs that can be used in a CU:

- Simple average of members’ import tariffs against nonmembers;
- Import-weighted average of members’ import tariffs against nonmembers;
- Consumption-weighted average of members’ import tariffs against nonmembers;
- Minimum import tariffs against nonmembers among members;
- Harmonized CET tariff with another customs union’s CET.

In the case of the ACU, any CET imposed by the ACU will have to honor member nations’ agreements with and commitments to the WTO (as reflected in a country’s bound rate). As a result, the lowest bound rate will represent the highest CET that the ACU can impose. With a ceiling of 11.3%, the lowest bound rate in the region, any ACU CET will have an impact on a majority of the GAFTA countries, as a majority currently has applied MFN tariff rates higher than 11.3%. Whatever the choice of CET, the implications of an adjustment by member countries is analyzed below:

- The CET leads to higher tariff rates for certain member countries:

  When the CET is higher than the national tariffs imposed by member countries, there will be a higher level of discrimination vis-à-vis third countries. This scenario could cause trade diversion in less developed economies that need to impose a CET aimed at protecting the industries of a more developed economy, thereby paying higher prices for imports from the rest of the world or switching to less efficient suppliers from a member country. In case consumers of a member country switch to a duty-free supplier from another member, then less customs revenues are collected by the first member country although the external tariff is higher. In some cases, the expansion of the protected market may lead to some tariff-jumping types of investments in the CU, motivated by the prospect of taking advantage of a larger, more protected market.

- The CET leads to a tariff that is lower than the national tariff rates

  If the establishment of a CU yields a CET that is lower than national tariff rates, then there is less motivation to switch to less efficient suppliers within the CU and therefore, trade diversion is reduced, and consumers will benefit from the lower tariff rates. In effect, the liberalization of trade will increase imports of member countries from the rest of the world (trade creation), which could help increase government revenues as dutiable imports from the rest of the world expand, although the tariff rates are lower. 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.

b) Lessons from other experiences of Customs Unions

The table in Annex A presents a summary of the main parameters of various CUs around the world and which is used to prepare the analysis below on the experiences of other CUs.

West African Economic Monetary Union (WAEMU):

Under the 1994 WAEMU Treaty, a decision was made to progressively harmonize the customs duties on goods from third parties between 1997 and 1999. Due to the fact that WAEMU member countries were already members of the Communauté Economique de l’Afrique de l’OUEST (CEAO), differences in national customs duties were minor, which facilitated the negotiations over the CET. WAEMU’s CET came into effect in January 2000 with 6 of the 8 countries applying it. The remaining two (Mali and Guinea-Bissau) came into compliance by the beginning of 2003.

The introduction of the WAEMU CET was aimed at achieving:

- The simplification of customs duties within WAEMU, in the face of a proliferation of duties and taxes, high tariff dispersion and relatively high overall tax levels—which increased the incentive for fraud;
The opening up of the WAEMU economies to the global economy;  
The protection of the production sector of the WAEMU economies, providing greater effective protection through low nominal tariffs on inputs;  
The prevention of trade diversion.

The WAEMU Commission undertook a study on the impact of the implementation of the WAEMU CU and presented the conclusions of the study at a conference in December 2005 in Mali. The study concluded that, although countries were applying lower customs tariffs under the WAEMU CET, budget revenue did not decrease due to the simplification and greater stability of customs taxation, and greater openness to international trade with a maximum duty of only 20%. Moreover, the simultaneous institution of accompanying measures, in particular the VAT, avoided any negative impact from the establishment of the CU. The study also concluded that there was an increase in producer and consumer welfare, thereby contributing to an improvement in the economies of the member countries.

Economic Community of West African States (ECOWAS)

The ECOWAS Common External Tariff, which is expected to come into effect on 1 January 2015, will be composed of 5 tariff bands (0%, 5%, 10%, 20%, and 35%). Essentially, the ECOWAS CET is based on the WAEMU CET as both CUs include some of the same member states. The ECOWAS CET was established to achieve a number of important regional objectives:

- Protecting the health of the population
- Protecting the environment
- Developing local production through increased value added
- Maintaining customs receipts as an important source of fiscal revenue.

Major obstacles to achieving a functioning CU include:

- the low level of economic and social development of the ECOWAS countries;
- the low level of intra-regional trade, with the countries essentially exporters of primary agricultural, mining and petroleum commodities to destinations outside the region;
- the weak institutional capacity and poor governance;
- the dependence of countries on customs duties as a source of public revenues.

East African Community (EAC)

The Protocol establishing the EAC CU was signed in 2004 and the implementation of the EAC CU commenced on 1 January 2005 over a five year period. With the coming into force of the Protocol, Partner States agreed to eliminate all the internal tariffs on trade between each other and decided that goods to and from Uganda and Tanzania shall be duty free. Goods from Uganda and Tanzania into Kenya were also to be duty free, however goods from Kenya into Uganda and Tanzania were grouped into two categories: category A goods were eligible for immediate duty free treatment, while category B goods from Kenya into Uganda and Tanzania had the present tariffs phased out over a five year period.

The introduction of the CET affected the pattern of protection. The CET introduced a very simplified structure that effectively increased Uganda’s tariffs but reduced those of the other two members. Almost all products were subject to CET rates of 0%, 10%, or 25% (the latter was the most common and applied to 40%
of tariff lines). The reduction in the spread and average rates of tariffs prior to the CET is reflected in a declining importance of import taxes in total revenue, which continued post-CET. Comparing the late 2000s to second half of 1990s, import duties as a share of total tax revenue fell significantly in Rwanda and Uganda, noticeably in Tanzania although only slightly in Kenya. Although tariff revenue remains significant, its importance is declining, at least in part reflecting growth in other revenue sources. As this trend can be expected to continue, revenue losses associated with the CU were viewed as a temporary adjustment cost to the establishment of the EAC (Adam Smith International, 2013).

Common Market of the South (MERCOSUR)

Established by the Treaty of Asuncion on 26 March 1991, MERCOSUR became a CU in 1994 after the signature of the Protocol of Ouro Preto. The governments from the four founding countries, Argentina, Brazil, Paraguay and Uruguay, agreed that the guiding principle for the construction of the CET in MERCOSUR was the stimulation of the foreign competitiveness of member states.

However, in the negotiation process for the construction of the CET, members had divergent positions on the tariff levels that should be applied to imports from third parties. The smaller economies of the bloc, Paraguay and Uruguay, were in favor of maintaining a structure with low rates of CET and minimal dispersion. On the other hand, Brazil and Argentina showed a preference for high level tariffs, which would be expected to serve as protection of local manufacturing outputs. Finally, in December 1994, the MERCOSUR countries approved the CET, which essentially represented the revealed interests of Brazil during the negotiation process and the CET came into effect on 1 January 1995.

3) Mechanisms for the Allocation and Collection of Customs Revenues

The issues of the ownership and collection mechanism of customs duties are important to consider during all negotiations of CUs. This is due to the potential for losses of tariff revenues which could result from the establishment of a CET or from changes in trade patterns.

The first question that arises is whether customs revenues are to be treated as community property or the property of each of the member states.

The EU is the only existing CU to treat customs revenues as community property to be used to cover budgetary expenditures. The European Union’s budget was designed to balance the cost of administering the EU with the benefits received by each Member State. Expenses are not allowed to exceed 1.24% of the GNI of the EU and the EU is not allowed to run a budget deficit. Article 269 of the Treaty establishing the European Union states that “without prejudice to other revenue, the budget shall be financed wholly from own resources”. There are three categories of own resources: traditional own resources, the VAT-based resource and the GNI-based resource. Traditional own resources include customs duties and sugar and isoglucose levies that are collected by Member States on behalf of the EU. Initially, Member States were allowed to retain 10% of the amounts collected to cover collection costs; however, this rate was increased to 25% in 2000 by a Council Decision (European Commission, 2008).

A fraction of the customs revenues collected is used by the EU for regional development initiatives and to support poorer countries. In the 1980s, the EU began implementing its own regional policy through the established “Structural Funds” – the European Regional Development Fund (ERDF) whose aim is to redress regional imbalances in the EU, and the European Social Fund (ESF) which aims to invest in people, with a focus on improving employment and education opportunities across the European Union, while improving the situation of the most vulnerable people at risk of poverty. In 1994, the EU also established the Cohesion Fund (CF) which is aimed at Member States that have a per capita Gross National Income (GNI) below 90% of the average of EU countries. It aims to reduce economic and social disparities and promote sustainable development (European Commission, 2014). Due to the fact that tariff revenues constitute a small portion of...
total government revenues for most EU Member States, EU members were more willing to forgo them and cede them to the Commission. Furthermore, pooling customs revenues required the establishment of a regional, supranational institution to ensure the smooth operation of the union as well as a certain degree of trust between member states (Andriamananjara, 2011).

In other cases, CUs treat customs revenues as the property of individual Member States, and there are two basic types of allocation mechanisms applied:

- Allocation according to the place of consumption (or final destination principle)

Most CUs allocate customs revenues according to the final destination principle in 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 appropriate duty amount. 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 are then transformed and shipped duty free within the CU instead of the member of final destination, a complex system of rules of origin, transit and guarantee mechanisms and internal border controls within the CU might be needed to determine the appropriate allocation of customs revenues to each member state. The New Computerized Transit System (NCTS), a computerized transit system based on exchanges of electronic messages, has been fully implemented among the 28 EU member states, the four European Free Trade Association member states (Iceland, Liechtenstein, Norway and Switzerland) and Turkey. The EAC member states have also implemented the RADDEEx system for systematic exchanges of information of transit goods (Yasui, 2014). This could discourage the 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 (Andriamananjara, 2011).

- Allocation based on some pre-agreed formula or percentage

Although no existing CU allocates customs revenues only at the point of first entry, a mechanism could be put in place that is similar to the EU in that member states collect the duties on behalf of the CU, 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 enhances 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.

The Southern African Customs Union (SACU) applies a fairly complicated revenue sharing formula system which is applicable to all members and which 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, Botswana, Lesotho, Namibia and Swaziland. The SACU expected real tariff revenue to decline over time, which justified the inclusion of excise duties thereby ensuring greater revenue stability and transfers to lesser developed economies. The revenue is shared following three basic components:

- 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.

- 85 percent of excise revenues are distributed on the basis of each country’s Gross Domestic Product (GDP). Since South Africa is the largest economy in the SACU, it usually retains the largest share of the excise revenues.
- 15 percent of excise revenues are distributed in near equal shares (20 percent) 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, in effect, it funds 93% of the development component and is considered its only net contributor (Kirk & Stern, 2003).

Implementation of the SACU revenue-sharing formula has revealed a number of opportunities and problems from which the ACU can learn. Because all customs and excise duties are collected at 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 the BLNS (Flatters & Stern, 2006). However, the following problems have also been revealed:

- There is a lack of clarity regarding the definition and components of intra-SACU trade which is the basis for the implementation of the customs component in the revenue sharing formula. Therefore, it 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 (Development Network Africa, 2007)
- Customs and Trade facilitation: 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 (Development Network Africa, 2007)
- Perverse incentives for expansion of SACU: 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 as they would benefit the most from the allocation of customs duties. This goes against the objectives of the SACU to improve economic integration and increase intra-union trade (Flatters & Stern, 2006)
- The lesser-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 members’ governments is rendered difficult (Flatters & Stern, 2006)
- The existing structure of the revenue sharing formula benefits the BLNS most as the main beneficiaries of the duties collected on their own imports and the imports of South Africa. Therefore, they have a strong incentive to maintain or even increase import tariffs and to avoid engaging in serious tariff reforms (Flatters & Stern, 2006).

For these reasons, Flatters and Stern (2006) suggest unbundling the development assistance from the customs collection objective of the SACU revenue-sharing formula. This would untie the development budget from the unstable trends and fluctuations of the customs and excise revenues, thereby removing the perverse incentive for member states to resist the liberalization of tariffs, while enabling the proper design of development programs suitable to the needs of the lesser-developed economies.

It is clear that the issue of collection and allocation of customs revenues is a difficult one for member countries to agree on, especially CUs with such disparate members. Jacob Viner’s classic work on CUs in 1950 summarized the difficulties faced by member states as follows: “... the greater the disparity in economic levels between the members, and the greater the differences between the members in the customary consumption of imported commodities, the greater is likely to be the difficulty in finding a formula for allocation of customs receipts which will be mutually acceptable”.

17
a) Revenue Effects:

The establishment of a CU will have an impact on government revenues, thereby affecting the fiscal balance of a government as well as inflation. The net fiscal effect from the choice of CET depends on the structure of government revenues and taxation tools used, as well as on governments’ dependence on customs revenues as a share of GDP. Therefore, member states must be cognizant of all the effects on the following components:

- **Tariff Revenues:**

  Governments will no longer be able to collect tariff revenues on trade with member countries. Furthermore, although member countries will receive tariff revenues allocated to them from trade with third parties, they might be diminished because there are central administrative institutions and functions within the CU that will need to receive funding, which will likely come from the tariff collected by the CU.

- **Excise and Value-Added Taxes**

  These rates are rather diverse among the CU countries. If a CU will have a harmonized tax policy, then excise and VAT will need to be harmonized as well, and the tax revenue implications of unified rates will need to be assessed on a country-by-country basis.

4) **Compensation Mechanisms**

There are three implications of establishing a CU that should render it a Pareto improvement for all members and, therefore, there should be no need for a transfer or compensatory payment:

- When customs revenues are collected at the first port of entry, member states benefit from a freer movement of goods within the CU and minimized intra-CU border controls as well as a decreased cost of customs administration;
- When CUs are formed, more commodities are purchased in bulk from outside the customs territory and are re-consigned to individual members. This creates economies of scale which lower the unit cost of the imports, thereby benefitting all member states;
- The CU creates a trade regime which eliminates border controls beyond the point of arrival of the goods and there is, therefore, no need for complex rules of origin which greatly complicate trade and increase its cost (Grynberg & Motswapong, 2003)

Positive effects of trade integration are known as trade creation effects that 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 will displace the production of goods from the less efficient country to the more efficient country. In turn, the price of goods will be lowered thereby increasing their domestic consumption which will cause an increase in revenues from taxes 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 (Walkenhorst, 2006).

In the case of low-income countries and particularly, least developed countries (LDCs), that rely heavily on trade taxes as a source of government revenue and that lack proper tax 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 CU 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 is necessary, not only for the fiscal position of governments, but also to ensure countries’ continuing membership in the CU (Grynberg & Motswapong, 2003).

Compensation mechanisms can be introduced by enacting lump-sum transfers to countries that suffer net welfare losses from the establishment of a CU. The work of Murray Kemp and Henry Wan (1976) in the area of compensation mechanisms is based on the following proposition which is independent of the number of partner countries, their size or development levels:

“Consider any competitive world trading equilibrium, with any number of countries and commodities, and with no restrictions whatsoever on the tariffs and other commodity taxes of individual countries, and with costs of transport fully recognized. Now let any subset of the countries form a CU. Then, there exists a common tariff vector and a system of lump-sum compensatory payments, involving only members of the union, such that there is an associated tariff-ridden competitive equilibrium in which each individual, whether a member of the union or not, is not worse off than before the formation of the union“.

There are two main objectives of compensation mechanisms:

- Compensation for revenue loss due to the adoption of a lower import duty

Revenue losses can arise as a direct effect of adopting a different tariff structure and eliminating import tariffs on intra-union trade. This is referred to as first order effects of CUs. For countries that will experience revenue losses when a lower CET is imposed as compared to their national rate, “losing” members’ 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.

- Compensation for Trade Diversion impacts of the CU

Trade diversion occurs when more efficient third party suppliers are displaced 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 the 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.

The level and structure of the 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 CU. If, on the other hand, formation of the CU 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 (Development Network Africa, 2007).

Most Revenue Loss Compensation Arrangements (RLCAs) involve the establishment of a compensation fund from which payouts for revenues losses are made, and include specific implementation characteristics, namely resource mobilization strategies, payout criteria and set durations. RLCAs are also seen as vehicles for economic solidarity weighted in favor of the poorer members. Therefore, many include a development component.
a) Resource mobilization

Resource mobilization schemes in RLCAs are classified according to whether they rely on existing or new revenue sources and whether they are based on domestic or trade taxes.

COMESA established a COMESA Fund which has two windows to address revenue losses in applying the CET: the Adjustment Facility which caters for revenue loss arising from the implementation of the COMESA trade liberalization programmes, and the Infrastructure Fund to finance infrastructure projects in the region. The COMESA Fund is intended to be temporary in nature because member states are expected to undertake reforms in their domestic tax systems in order to raise more revenues. SACU also has a common revenue pool to which customs duty revenues are allocated. ECOWAS and WAEMU, on the other hand, apply surcharges to third country imports. The EU implements compensation indirectly through the established “Structural Funds” and the “Cohesion Fund” which use a fraction of the customs revenues collected in order to support regional development initiatives and to support poorer countries. All RLCAs are at least partly based on earmarked trade taxes which protect the compensation fund from annual budget discussions in member states, but which expose it to the volatility of the revenue source (Walkenhorst, 2006).

b) Payout criteria

RLCAs depend on the level of incurred revenue losses and the share of intraregional trade as the bases for the payout criteria. SACU’s customs component in its Common Revenue Pool is based on a share of intra-union trade. Schemes based on historical trade patterns or aggregated international trade shares are less cumbersome to handle than those centered around shipment-specific customs declarations. However, more and more customs administrations are relying on computers which make tracking shipments easier and more reliable.

c) Duration of arrangements

Many RLCAs are devised to be temporary in nature because of the expectation that member states’ revenues will increase due to the fact that value-added taxes, excise and income taxes will increase over time as intraregional trade expands. The period of operation of an RLCA may be predetermined and limited for a number of years, or may be decided on a case-by-case basis. In some cases, such as in the SACU, the Common Revenue Pool has no end date. In general, compensation payments are expected to be scaled down over time as an incentive for countries to implement their own fiscal reforms.

V. Summary of findings

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

Due to the disparities in the level of economic development in Arab countries, negotiations to establish the ACU might prove to be difficult. Any discussion of the implications of joining the ACU must begin with an understanding of the current dependence of the Arab region’s countries on taxes derived from international trade. An analysis of the implications also needs to factor in the specific tax systems and instruments different countries have implemented; while some countries depend solely on tariffs to derive revenue from imports, other countries have multiple tax tools in place such a VAT and/or excise taxes. Those countries
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 by a lower CET and a loss of tariff revenue on imports from other ACU member countries. Those countries that rely entirely on tariffs to generate revenue on international taxes will face a greater challenge compensating for the loss resulting from joining the ACU.

The benefits of the ACU will also differ depending on the tariff structure adopted. The net economic effect of the ACU depends on how the adjustment of the external tariff affects the degree of discrimination vis-à-vis nonmember countries. 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 countries that will have to increase tariffs on certain products while reducing them on others, with the actual impact being dependent on the balance chosen.

It is expected that the establishment of the ACU will yield a CET that is lower than some countries’ national tariff rates. In this case, government revenues are expected to increase, although tariff rates are lower, 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.

In order to reap equitable benefits from a CU, 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 the ACU.