INDIRECT TAXATION AND BUDGET VULNERABILITY IN THE MEDA COUNTRIES: A NOTE

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1. Introduction

It is widely accepted that trade liberalization enhances economic efficiency and accelerates growth. Nevertheless it faces with the challenges imposed by any intra-regional economic integration to the tax structure. As trade barriers come down and capital mobility increases, the challenges for emerging countries become particularly acute, because taxes on international trade are a large source of revenue and their tax administration capabilities are generally poor.

Despite a declining trend over the world, taxes on international trade accounted in 1995 for about 5.5% of GDP in Africa, 3.6% in non-OECD Asian countries and 3.6% in the Middle East (Ebrill *et al*., 1999).

Two different tax policy issues are strictly related to the economic performance of the MEDA countries (henceforth MEDAs): the tax revenue consequences of trade reform due to a reduction in foreign trade taxes and the increasing tax competition for foreign direct investment (FDI).

As non-tax barriers decline, investment decisions and location of investment become more tax sensitive. Within free trade areas firms can supply different national markets from a single location. The relevant issue here is the temptation for such countries to broaden the scope of tax incentives to attract and compete for FDI. The main argument in favour of these national policies is that FDI can contribute to increase productivity of the domestic economy, but the effectiveness of tax incentives is highly questionable (Bernardi *et al*., 2005). Moreover, as noted by Tanzi and Zee (2000), a tax system that is riddled with such incentives will inevitably provide fertile grounds for rent-seeking activities. Recent evidence (OECD, 2001) suggests that tax incentives can have effects on the location of investment, especially between locations that are similar in other respects. However, it is also recognized that neighbouring countries within a region could compete against each others in offering tax incentives in a way that provides benefits to the investor without increasing the total amount of FDI allocated to the region.

However, in this note we want to focus on the first tax policy issue related to the budget vulnerability of the MEDAs. This is a straightforward consequence of loss in tax revenue due to trade reforms and it implies a broader analysis of the indirect taxation system. Indeed the revenue implications of trade liberalization are uncertain: according to Tanzi (1999) the revenue impact of trade reform is just an empirical matter with important differences in short and long-term consequences depending on country's initial conditions and reform ingredients. Abed (1998), focussing on Southern Mediterranean countries, points out the strict link between trade liberalization consequences and domestic tax reforms.

The remainder of this paper is organized as follows. Section 2 provides a snapshot of some important elements of the taxation theory about the relationship between indirect and trade taxes and in the following Section 3 some recent tax revenue statistics of the MEDAs are presented in order to evaluate the ongoing tax reform processes.

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2. Elements of indirect taxation theory

On the one hand, it is well-known that new free trade areas produce economic benefits to the countries involved in terms of increased bilateral trade, greater economic efficiency and increased bilateral FDI. On the other hand progresses in economic integrations pose new challenges: intensified competition in domestic markets, loss of tariff revenues, possible temporary unemployment.

Heady (2002) pointed out that differently from developed countries, developing countries and emerging markets still rely on custom duties and less on internal sources. The difference in revenue patterns is mainly explained in terms of administrative convenience as for a developing country it is relatively easy to observe and evaluate goods as they cross international frontiers. For different reasons, trade taxes on imports have been often introduced to protect domestic production and those on exports reflect in part the export of primary products over which the country has some monopoly power.

Standard economic theory suggests that taxes on international trade have a major distortion effect and that efficiency gains deriving from their reduction, in the long-term, far outweigh the loss of such revenue sources. As a general principle, it is well-known that it is optimal for a small open economy to raise any revenue it needs by setting all tariffs to zero and relying entirely on destination-based taxes on consumption (Dixit, 1985). Keen and Ligthart (2002) formally show that any tariff reduction that increases production efficiency, coupled with a consumption tax reform which leaves consumer prices unchanged, increases both welfare and public revenue.

The reduction of taxes on import trade often runs into serious political opposition, due to the pressure of domestic producers. Moreover, one of the most important constraints to trade reform in such countries is the conflict between tariff reforms and macro-stabilization goals (Mitra, 1992). Concerns on the revenue losses may be exacerbated by the short-term expenditure pressures that can arise, due for instance to increases in social outlays for displaced workers (IMF, 2005*b*).

For a number of countries the adverse revenue impact of tariffs reductions could be redressed in the short run by reducing existing exemptions, by removing highly restrictive non-tariff barriers and relying on the expected import volume growth. But in the long run it will require the implementation of compensatory revenue measures (Tanzi and Zee, 2000), like: broadening of the tax bases, reviewing the existing exemptions and preferential regimes in the field of indirect taxation (turnover taxes, VAT, import duties) in order to verify their justification and effectiveness; compensating for tariffs reductions on excisable imports by an increase in their excise rates; increasing the rates of the general consumption taxes (VAT, sales taxes, turnover taxes).

More generally, as noted by Zee (2004), this process will induce policy-makers in developing countries and emerging markets to fundamentally reform and modernize their tax systems by virtue of necessity rather than choice.

As a general principle, attempts to reform the structure of protection trade taxes cannot ignore the role of the domestic indirect tax structure since the latter can – and in many countries does – affect protection (Mitra, 1992). In many cases the World Bank (Rajiaram, 1992) made reference to the need to “harmonize” the domestic tax treatment of imports and domestic production, given that an asymmetric treatment of domestic and imported goods under the domestic indirect tax system implies that domestic indirect taxes may add to the protective effect of trade taxes.

A central issue in tax policy design is to what extent the MEDAs should be encouraged to move away from trade-based taxes and existing commodity taxes towards broader consumption taxes.

There are conceptual merits in using domestic consumption taxes – mainly general sales taxes like the VAT, but also excises on particular goods – to offset any revenue loss from tariff reduction (IMF, 2005*b*). A strategy of matching a reduction in the tariff rate on some final consumption good with an increase in the corresponding domestic tax on consumption on that same good will leave for a small open economy the price faced by consumers unchanged, but the government's total tax revenue will increase, since these revenues are now collected on all consumption, domestically-produced as well as imported.

There are also practical merits in this strategy. Like trade taxes, also a considerable part of excise and VAT revenues are collected at the border (many developing countries collect more than half of their VAT revenues from imports) using the same administrative organization.

The arguments in favour of using the VAT rather than trade taxes and other commodity taxes are well-known (Heady, 2002): because the tax base is much larger (it also includes services), tax rates can be lower and so lower are the distortionary effects; through the destination principle it does not distort relative prices in international trade; finally, the self-enforcing mechanism means that compliance is generally higher.

There is, however, an important structural feature of a developing country that militates against the desirability of VAT: the existence of a large informal sector that escapes the VAT. While a radial (across the board) uniform reduction in trade taxes reduces the production distortions, a revenue-neutral radial increase in VAT increases the inter-sectoral distortions between formal and informal sectors. As a result, such a reform can reduce welfare (Emran and Stiglitz, 2005). Also Hines (2004) concludes that increasing consumption taxes definitely fosters the expansion of the hidden economy.

Another challenge the existing VAT systems face is strictly related to trade liberalization. As well-known with respect to international trade the standard approach is to levy the tax on domestic consumption through the destination principle, which assures production efficiency even in the presence of differentials in national tax rates. Around the world recent trends toward regional integration, the development of the Internet, the growth in trade involving services and intangibles and the trend toward the reduction of traditional custom formalities complicate the implementation of the destination principle (Keen, 2003). In the MEDAs further difficulties arise when the zero-rating has to be applied to exports, which require the appropriate refunding of excess VAT input credits to exporters (Choon, 2002). As trade barriers come down methods to address these situations will be increasingly critical.

Nevertheless, the presence of a VAT does not in itself appear to enhance the ability to recover revenue. Excises also play an important role in the transition from trade taxes to domestic consumption taxes, since excisable goods are often a large part of the import base. In those countries with high revenue recovery, there has also been a strengthening of income tax revenues, suggesting that the burden of adjustment has not been borne solely by shifting to taxes on consumption.

Generally, most of the MEDAs – like other transition or developing countries – face difficulties in the VAT's administration due to its complexity. On the one hand, the adoption of the VAT is often seen as an opportunity for overall tax administration modernization (ITD, 2005). On the other hand, the administration of the VAT is more difficult in these countries where underground or shadow economies are considerably larger as compared to developed countries (Bird, 2005). The risk is that increasing the tax can foster the expansion of the underground economy, especially when the labour-intensity of production in the informal sector is greater than in the formal one (Hines, 2004).

3. Revenue indicators and trends in the MEDAs

According to one of the pillars of the Barcelona Process (started with the Barcelona Declaration in 1995) a Euro-Mediterranean Free Trade Zone (EMFTA) should be established by 2010.

Nowadays most of the MEDAs form a bloc of countries where economic cooperation and integration have been strengthened under Associate Agreements with the EU (AAEU): Algeria (in process of ratification), Egypt (2004), Jordan (2002), Lebanon (in process of ratification), Israel (2000), Morocco (2000), Palestinian Authority (1997), Tunisia (1998), Turkey (1995). Moreover Syria has concluded the negotiations in October 2004 completing the grid of AAEU, whose main aims are to implement both vertical and horizontal trade liberalization of manufactured goods and agricultural products.

Moreover, some of the MEDAs join the Great Arab Free Trade Area (GAFTA). This zone, including some 40 States and almost 800 million consumers, is one of the world's most important trade entities and it is making significant progress in trade and investment liberalization by the lowering of tariffs in intra-regional trade.

On the one hand, this process is likely to encourage competition among countries and to improve economic efficiency in the region. The most recent evidence confirms a good economic performance in particular in Algeria, Morocco, Tunisia and Jordan with a great success in achieving macroeconomic stability, due to a consolidated growth and to the effect of a number of structural reforms. Preserving macroeconomic stability, enhancing further sustainable growth performance, reducing unemployment and poverty are among the greatest challenges for most of the MEDAs. They need to strike a balance between tariff reforms and macro-stabilization goals (Mitra, 1992) both in the short and in the long run.

On the other hand, the liberalization process raises the important issues of budget vulnerability and tax revenue composition (Nashashibi, 2002). The need of a general consumption tax reform should be considered in all countries (Keen and Ligthart, 2002). Indeed, in most of the MEDAs taxes on international trade still represent more than 10% of the total current revenue. The loss of this important revenue source will be particularly serious for countries with a critical budgetary situation, such as Lebanon and Egypt.

The following Tab. 1-2-3 and 4 show the most recent revenue statistics available for Algeria, Morocco, Jordan and Syria.

Tab. 1 – Algeria: central government revenue by main categories

	1989-90	1999	2000	2001	2002	2003
Total revenue	37.3	29.2	38.5	35.0	36.1	38.1
Tax revenue	16.3	9.7	8.5	9.3	10.8	10.1
Corporate taxes	1.9	1.2	1.1	1.3	1.3	1.2
Individual income taxes	3.1	1.0	0.9	1.1	1.2	1.2
Import duties and taxes	2.6	2.5	2.1	2.4	2.9	2.8
VAT	7.8	3.2	3.2	3.2	3.2	3.2
Excises	0.9	1.3	1.2	1.2	1.4	1.2
Registration and stamp taxes	--	0.4	0.4	0.4	0.4	0.4
Non-tax revenue*	21.0	19.5	30.0	25.7	25.3	28.0

- *Note*: (*) including hydrocarbon revenue fees. Values in % terms of GDP.

Source: IMF (2005*a*); Nashashibi (2002).

Tab. 2 – Morocco: central government revenue by main categories

	1989-90	1999	2000	2001	2002	2003
Total revenue	24.5	28.2	26.6	25.0	24.7	24.5
Tax revenue	22.4	26.1	24.4	22.8	22.9	22.5

Corporate taxes	3.9	4.2	2.9	3.1	3.2	3.5
Individual income taxes	1.6	3.4	3.4	4.1	4.1	4.2
Import duties and taxes	4.7	4.7	4.8	3.7	3.6	3.0
VAT	5.6	6.1	6.1	6.1	6.0	6.2
Excises	5.0	5.8	4.3	4.1	4.0	3.8
Registration and stamp taxes	--	--	1.2	1.2	1.3	1.3
Other taxes	1.6	1.9	1.7	0.6	0.6	0.5
Non-tax revenue	2.1	2.1	2.1	2.2	1.8	2.1

Note: Values in % terms of GDP.
Source: IMF (2005*c*); Nashashibi (2002).

Tab. 3 – Jordan: central government revenue by main categories

	1989-90	**1999**	**2000**	**2001**	**2002**	**2003**
Total revenue	27.1	27.5	25.9	26.1	24.9	23.6
Tax revenue	14.4	15.3	16.1	16.1	14.9	15.3
Corporate taxes	3.3	1.8	1.8	2.2	2.0	1.9
Individual income taxes	1.0	0.9	0.9	0.9	0.9	0.9
Import duties and taxes	4.4	4.8	4.4	3.8	3.3	3.0
GST	--	6.5	7.8	8.1	7.6	8.4
Excises	4.5	1.0	0.9	0.8	0.8	0.9
Other taxes	0.8	0.4	0.4	0.3	0.3	0.3
Non-tax revenue	12.7	12.2	9.8	10.0	10.0	8.2

Note:
Values in % terms of GDP.
Source: IMF (2004); Nashashibi (2002).

Tab. 4 – Syria: central government revenue by main categories

	1989-90	**1999**	**2000**	**2001**	**2002**	**2003**
Total revenue	22.5	26.5	27.2	32.1	29.7	30.3
Tax revenue	16.9	11.4	9.8	9.7	11.4	11.1
Corporate taxes	6.8	4.2	4.2	2.8	3.4	2.8
Individual income taxes	--	0.7	0.7	0.8	0.8	0.9
Import duties and taxes	1.3	2.1	1.6	2.1	2.5	2.7
GST	--	0.3	0.1	0.2	0.3	0.8
Excises	6.9	1.7	1.4	1.5	1.7	1.3

Registration and stamp taxes	--	0.9	0.9	0.9	1.1	1.1
Other taxes	1.8	1.4	0.9	1.3	1.7	1.6
Non-tax revenue*	5.6	15.1	17.3	22.4	18.3	19.2

Note: (*) including oil-related revenue fees. Values in % terms of GDP.

Source: IMF (2005*d*); Nashashibi (2002).

Two important points emerge clearly from these updated figures.

First, some countries still rely heavily on non-tax revenue: it represents 28% of the total revenue in Algeria and 19% in Syria. Two different sources of revenue can be responsible for it:

the utilization of natural resources (Algeria and Syria, but also Egypt) and public ownership of enterprises (Jordan, Syria and Egypt). Both of these sources are likely to decline with the liberalization of the economy and they should be replaced by other taxes.

Second,

tariffs and import duties have been undergoing simplification and rationalization.

The challenges vary with the degree of economic development. In the MEDAs the role of trade taxes is stable from 1990 to 2000, accounting for about 4.3% of GDP.

Nevertheless, the consequences of

the trade agreements are evident. On the one hand, countries that joined the AAEU, such as Morocco and Jordan, show a substantial decline in import tax revenues since 2001 (-37% between 2000 and 2003 in Morocco, -32% in Jordan). On the other hand, other countries whose associations in the AAEU are still in process of ratification, such as Algeria and Syria, show an increase in the relative importance of import duties and taxes (+33% between 2000 and 2003 in Algeria, +69% in Syria).

This can be considered as a direct short run quantification of the effects of trade agreements on the tax revenue. Generally, the decline in tariff revenue in emerging countries around the world is underway. According to Zee (2004) tariff revenue in non-OECD countries accounted for 22% of total tax revenue in the first half of 1990s and for 17.4% in the second half. The comparison with the OECD countries figures (respectively, 1.9% and 1.4%) suggests that the process will continue in the future.

As a consequence, in the long run the trade liberalization process will require the implementation of compensatory revenue measures (Whalley, 2003), increasing the rates of the general consumption taxes (VAT, general sales and turnover taxes). This strategy has been often recommended by the World Bank and the International Monetary Found (IMF) through a sequencing tariff reform with strengthening of domestic consumption taxation, often in the form of a value added tax.

In order to be aware of the extent to which the MEDAs have already reformed their tax structure, Tab. 5 summarizes the indirect taxation system in most of them at the beginning of 2004.

Currently the large majority of the MEDA countries apply a multi-rate consumption tax in the form either of a Value Added Tax (Algeria, Lebanon, Morocco and Tunisia) or a General Sales Tax (Jordan and Syria). Considerable progress has been achieved in Lebanon, Morocco and Tunisia. In other countries (Egypt and Syria) tax and tariff systems remain complex and inefficient: they do not follow the internationally recognized best practices due to numerous exemptions and multiplicity of rates.

Generally the choice of a multi-rate tax mainly depends on balancing tax administration arguments – favouring a single rate structure – against the availability of other instruments better targeted to achieve distributional objectives – the absence of which tends to favour multi-rate structures. Nevertheless a multi-rate tax is the result of unclear segmentations and overlaps.

In the countries of the Maghreb region (Algeria, Morocco and Tunisia) a VAT is levied since the late 1980s over a broad range of goods and services with standard rates between 17% and 20%. In the Mashreq region (Egypt, Jordan, Lebanon and Syria) the indirect tax regime is more differentiated: Egypt and Jordan apply a General Sales Tax since the early 1990s with a standard rate respectively equal to 10% and 15%; Lebanon introduced a VAT in 2002 with a standard rate at 10%. In Syria a General Sales Tax was introduced in 2004 on a narrow bunch of goods and services.

The revenue from the consumption tax reflects such institutional differences: in Morocco the revenue from the VAT in 2003 is around 6% of the tax revenue and in Jordan the General Sales Tax accounts for 8.4%. At the opposite extreme, the GST revenue in Syria in 2003 accounts for 0.8%, but this figure does not take into account the introduction of the new General Sales Tax.

Table 5 – Indirect taxes

	Algeria	Egypt	Jordan	Lebanon	Morocco	Syria	Tunisia
Broad-based consumption tax							
	VAT	GST	GST	VAT	VAT	GST	VAT
Year of introduction	1990	1991 *a)*	1994 *b)*	2002	1985	2004	1988
Coverage	Broad	Broad	Narrow	Broad	Broad	Narrow	Broad
Standard rate (%)	17	10	15	10	20	15	18
on			Tourist services (hotels, restaurants, transports), IT services, consultancies, commercial and cultural services	All transaction with the exception of: medical, education, insurance and banking services, some vegetables, books.		building materials, electrical equipment, cars	
Reduced rates (%)	7	5			7-10-14	10	6-10 *e)*
on	Basic foodstuff, pharmaceutical products, energetic products.	Foodstuff, services rendered by artists, locally produced medicines, local telephone services, service of tourist holes and transports			7%: general consumption goods and activities of the liberal professions. 10%: catering services, hotels and building activities related to tourism; 14%: building activities.	Jewelery, hotels and restaurants	6%: import, pharmaceutical products, electricity, gas. 10%: activities of the liberal professions, training services
Increased rates (%)		15-20-30	20			30-33-35	29
on		Communication services; durable goods, vehicols; electric equipment, luxury cars	Luxury products			30%: airline tickets. 33% animal and vegetable fats and oils. 35%: alcoholic drinks.	Luxury goods
Excises							
	Yes	Yes			Yes	Yes	Yes
on	Alcoholic drinks, cigarettes, tobacco, foodstuff, motor vehicles	Vegetables, oil, alcohol and tobacco.			Alcoholic drinks, gold, silver and platinum.	Gasoline and kerosene.	Foodstuff, drinks, petroleum and gas products, jewellery, vehicles and electric equipment
Tariffs							
Quantitative restrictions			Yes	Yes		Yes	
Rates (%)	5-30	2-40	15-30	0-90 *c)*	2.5-50	1-100 *d)*	10-5(
Surcharges	flat		0.5-2			2	

VAT: Ad Valorem Tax. GST: General Sales Tax **a)** This tax is to be implemented in three stages: in stage one it is levied on industrial producers, service suppliers and importers. In stage two, it is levied on wholesalers and in stage three on retailers as well. Currently tax is levied only on its stage one.**b)** This tax is to be implemented in two stages: in stage it is levied on manufacturers, importers and supplier of services. In the second stage, it is levied on wholesalers and retailers. Currently tax is levied only on its stage one. **c)** Tariffs on agricultural products 70%, on industrial goods between 5% an 10%. All product from Syria are subject to a reduction of 25% on duties from 1998. **d)** There are also two taxes on export: 12% vegetables, fruit and derivatives; 9% on all other agricultural products. **e)** A reduced rate equal to 6% applies to the imported goods with an increase of 25% in their tax base. Sources: IBFD (2005a), IBFD (2005b), IMF (2004), IMF (2005a), IMF (2005c), IMF (2005d)

Over the past few years, many excises have been transformed to *ad valorem* rates but others remain specific and inadequately adjusted for inflation (Abed, 1998). Nowadays, most of the MEDAs levy excises on alcoholic drinks, tobacco, foodstuff (Algeria, Egypt and Tunisia), gasoline and kerosene (Syria) luxuries (Morocco and Tunisia). Generally they account for around 1-1.3% of the tax revenue, with the exception of Morocco where they represent 3.8% of the tax revenue.

In general, the consumption tax performance in these countries is still much under its potential, mainly as a consequence of the existing exemptions and of the large informal sector. The taxes are often limited to a small number of economic sectors or goods and services. Exemptions and preferential tax treatment should be minimized as they create distortions and difficulties in the administration and compliance of the tax. Nevertheless, administrative systems for the VAT in Morocco and Tunisia are relatively better developed than in other MEDA countries with an efficiency ratio of about 65% (Abed, 1998).

To sum up, over the past few years a number of structural reforms have been implemented as the introduction of broad-based consumption tax in Lebanon (and, to some extent, in Syria) and the consolidation of rates in Algeria, Morocco and Tunisia. However, the general effects in terms of revenue are far to be easily assessed: with the data available it is difficult to predict the long run trend of the tax revenue. Nevertheless, the international lesson in terms of revenue consequences of trade reform and tariff reduction poses serious challenges. In a recent work based on a panel of 125 countries over 20 years, Baunsgaard and Keen (2005) find that low-income countries typically are able to recover only a small percentage of lost trade tax revenue, even over the longer-term.

This should encourage the MEDAs to implement a more vigorous reform of domestic tax systems, including also a reform of individual income and corporate taxes, in order to take advantage of the economic benefits of a more liberal trade regime (Soderling, 2005) and to avoid increasing their own budget vulnerability.

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