

trade hot topics

Managing Fiscal Adjustment Costs of Regional Trading Arrangements: The Case of Small Island Pacific States

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Background

The fourteen island member states of the Pacific Islands Forum—hereinafter referred to as the Pacific Island Countries or ‘PICs’—are some of the smallest and geographically most isolated countries in the world.¹ Despite their small size, limited negotiating capacity and miniscule share of world trade, they are embarking on a number of ambitious North–South regional trading arrangements. This issue of *Commonwealth Trade Hot Topics* highlights some policy challenges facing small states in trade negotiations, and proposes options for managing fiscal adjustment costs emanating from these processes.

Six steps towards managing fiscal adjustment losses

There are a number of potential concerns for any small state when they embark on reciprocal (that is, involving liberalisation by both parties) trade arrangements, including *inter alia* protecting revenue, safeguarding domestic industries, helping develop and diversify export base, protecting vulnerable social groups and ensuring that aid is targeted towards national development objectives. In the context of tariff liberalisation, quite often the

concerns over revenue loss weigh the heaviest for small island policy-makers. In many of these countries, the public sector is not only the largest employer but also the main provider of social services, infrastructure and investment. A sudden revenue loss can have severe political, economic and social consequences.

In a series of Commonwealth studies on the Pacific Islands regional integration negotiations, a six-step approach for managing potential fiscal adjustment fallout of a trade agreement has been identified. This is summarised below.

Step 1: Consider the profile of total domestic revenue, not just trade revenues.

The fiscal picture is often considered in a narrow context — for example, by solely focusing on percentage losses of import duty revenues. It is however the change in total domestic revenues—comprising *inter alia* income, value-added/consumption taxes, excise and other taxes—that ultimately determines the budget envelope. In the case of the Pacific Islands for example (see Table 1),

¹ These include Cook Islands, Federated States of Micronesia, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tonga and Tuvalu.

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the reliance of the public purse on import duties varies significantly—from 2 per cent in the case of Papua New Guinea to 60 per cent in the case of Tuvalu. This implies that even within a single region, the potential flexibility of trade negotiators can differ significantly based on the composition of domestic revenue.

Table 1: Share of import duties in Pacific Island total domestic revenue

Federated States of Micronesia	29%
Fiji	10%
Kiribati	50%
Marshall Islands	18%
Palau	19%
Papua New Guinea	2%
Samoa	11%
Solomon Islands	8%
Tonga	6%
Tuvalu	60%
Vanuatu	27%

Source: Authors' compilation from different sources.

More importantly, negotiators could consider the changing profile over time of domestic revenues. Many PICs have undertaken sweeping changes to their revenue regimes, changes that over time have simplified tariff structures, diminished the role of import duties in domestic revenues and boosted the role of internal taxes (particularly income, excise and VAT) that are not subject to reduction in tariff negotiations. In the case of Tonga for example, tax reforms have reduced the share of import duties in total domestic revenue from 25 per cent to 10 per cent. Looking into the future, the role of import duties is likely to fall even further for some countries due to implementation of the regional trade agreements, accession to the World Trade Organization, and ongoing domestic tax reform programmes.

Step 2: Examine both the volume and treatment of trade flows between both partners.

The second step towards managing trade-related fiscal losses is to review the detailed, line-by-line reality of trade flows among the trading partners. In the case of the PICs, trade with major developed economies is concentrated in a small number of tariff lines, generally food/agricultural goods (that sometimes enter under high tariffs) and heavy machinery (that enter under low tariffs or duty-free). This detailed analysis is key to managing the fiscal impact, given that the liberalisation or

protection/exclusion of a handful of tariff lines can make the difference between a manageable fiscal impact and one that may result in reductions in government payrolls and spending programmes.

One important aspect of trade flows that requires close examination is duty exemptions. All too often in trade impact studies, there is a blanket assumption that all imports are charged full duties, leading to an overstatement of the potential fiscal loss and misallocation of negotiating capital on goods that are not relevant from a revenue perspective. In the case of the PICs, exemptions play a strong role. In Solomon Islands, for example, nearly half of the value of all imports is subject to duty exemptions, largely for aid projects, telecommunications infrastructure and raw materials. For other countries such as Samoa and Tonga that have undertaken deep fiscal reforms and zero-rated many previously exempted goods, the level of exemptions is much smaller.

Finally, it would be prudent for negotiators to consider the changing composition of trade flows as well. In several PICs, trade and investment links with Asian economies (particularly China) are beginning to grow stronger, and in some cases, outpace those with traditional partners such as Australia, New Zealand and the USA. While regional trade liberalisation can lead to welfare-decreasing trade diversion (i.e. reduce tariffs and thus increase imports from regional trading partners), these longer-term changes in trade relationships can have a significant impact on revenue losses over time.

Step 3: Build realistic, detailed scenarios based on the potential building blocks of the national offer.

The eventual revenue loss is contingent on the final liberalisation package that results from the negotiations. While it may be difficult to predict the final tariff liberalisation offer, trade negotiators can build a range of realistic and detailed scenarios for the national offer on the basis of different policy priorities. These priorities, which are likely to differ between countries, could include, *inter alia*, the protection of revenue, production and employment; ensuring that product-specific positions are consistent with existing regional trading commitments; and enhancing competitiveness and consumer purchasing power by liberalising tariffs on key inputs into domestic production and consumer staples.

The key for PIC negotiators is to be precise and judicious in their choice of products to exclude from liberalisation. All too often trade negotiators

choose a very imprecise means of excluding products, generally taking a very disaggregated view (i.e. excluding entire chapters when only a few tariff lines are actually sensitive) or considering an unrealistic approach (i.e. excluding sectors that have low likelihood of domestic production, or that are highly unlikely to feature prominently in the import basket). The Commonwealth studies, including those relevant to PICs, show that for small states, any number of policy priorities — including protecting a large share of revenue, protecting the basic domestic industry that exists, and protecting key regional priorities — can be accommodated as long as negotiators are precise about which products are truly sensitive.

Step 4: Estimate the trade and revenue impacts.

It is impossible to predict the actual changes in trade flows (and thus exact revenue impacts) *ex ante* — there are simply too many variables to accurately capture, including changes in consumer behaviour, prices, and shifting trade dynamics. This is particularly true for Commonwealth small states that do not have the requisite data to undertake comprehensive quantitative assessments of tariff policy changes.

Negotiators, however, can take account of estimated impacts available using less-demanding quantitative tools (such as partial equilibrium models used by trade economists) that can provide first-hand assessments using limited information. These exercises can be undertaken without much difficulty using current data on tariffs and trade flows. The resultant analyses would allow negotiators to better appreciate the effects of tariff changes on local prices, public revenues from imports, and domestic production with further implications for revenues. Several scenarios can be built based on differential tariff policy regimes with regional partners vis-à-vis the rest of the world.

Step 5: Determine the potential social and economic impact of a ‘worst-case’ scenario.

In order to prepare potential policy measures before undertaking trade negotiations, policy-makers should consider the possibility of a ‘worst-case’ fiscal loss scenario *without any attempt to recoup trade-related losses* through changes in the tax structure or increased development aid.

There are two main difficulties, however, in establishing precise impact scenarios. First, government spending is conditional on budget procedures and political considerations that are not only difficult to predict but often have a weak link

to trade policy outcomes. Budgetary spending can suddenly shift due to electoral cycles, debt service commitments, sudden surges in external aid/investment, or global cycles such as the recent recession. Second, economic predictions in the social and economic sectors are contingent on the availability of reliable, disaggregated and timely data. In many PICs, this data is either unavailable for recent time periods or covers only some formal economic activity.

These difficulties notwithstanding, there are a number of potential fiscal impacts (both direct and indirect) that policy-makers could consider when undertaking trade liberalisation, including: the tightening/elimination of duty exemptions for the public and private sectors; a reduction in financial support for public infrastructure/utilities, publicly-owned corporations and supporting/funding bodies for the private sector; a decrease in the government’s spending ambitions in key social sectors, particularly in health and educational services; and cuts in the public sector wage bill.

The impact on vulnerable groups, such as people living in rural areas and women, is particularly difficult to measure given that national surveys in many different countries seem to suggest that the economic livelihoods of these groups are largely tied to subsistence-based agriculture/primary activities. Thus apart from the provision of educational and health services, it is difficult to establish a causal/formal link between trade liberalisation, budgetary outcomes and the social well-being of Pacific Island vulnerable communities.

Step 6: Take policy measures to minimise the potential fiscal losses from tariff liberalisation.

The ideal policy measure to mitigate the fiscal impact of trade liberalisation is *donor-assisted tax reform*, well in advance or explicitly linked to undertaking liberalisation commitments. In some PICs for example, the tariff reductions of previous years have already significantly reduced budgetary reliance of revenue on import duties; key reforms, such as introduction of consumption taxes and the replacement of import duties with excise taxes, have allowed these taxes to constitute a major source of government revenue with a much higher share than import duties. Even these ‘first-mover’ countries however require significant long-term technical assistance.

The resources required to correct institutional gaps imply that goods liberalised under assumed changes

in fiscal instruments may require long grace periods for tariff reduction. Studies have shown that developing countries can require up to 10 years to recoup the tax losses from trade liberalisation. In some PICs, for instance, at least 36 months are needed for changes in tax laws to become operational. This implies that even basic changes in fiscal instruments (i.e. moving from import duties to excise taxes), let alone the introduction of new instruments (e.g. value-added taxes), require a time period for national authorities to both test and implement any new taxes with maximum policy space to correct errors and improve collection. Commonwealth small states could also consider safeguard clauses. An example relevant for PICs is Article 45 of the interim Economic Partnership Agreement signed between the European Union, Fiji and Papua New Guinea, specifying *inter alia* that where a PIC is under threat of a 'serious decline' in its fiscal position and particularly in revenues from customs duties, the country in question may impose/increase tariffs for a set time period in order to remedy the adverse fiscal consequences.

The key for negotiators is a realistic appreciation for the domestic capacity to undertake wide-ranging tax reforms. All too often, fiscal impact studies treat the fiscal reform issue flippantly, merely stating that trade liberalisation 'will not be a problem' if there is a move towards lessened reliance on import duties, and a greater reliance on excise and internal taxes. This is contrasted with the reality where many small states continue to rely on border taxes due to their enclave characteristics and the ease of collecting trade transaction duties vis-à-vis internal taxes. In addition, import duties for many products are charged for revenue purposes only and thus could be relabelled as excise taxes given that there is no domestic production (e.g. import duties for vehicles and fuel). This however has not been done in many PICs, either because the pressure to lower such import duties has only emerged from the context of trade negotiations, or because of gaps in domestic tax capacity that impede large-scale reforms in revenue collection.

While deep liberalisation commitments can be an important spur to beneficial changes in the domestic tax regime, negotiators must avoid a situation where deep cuts in import duty revenues are not matched by new fiscal instruments that can maintain budgetary spending over time. Changes in the tax regime should be coupled with regular review, rationalisation and performance targeting of public expenditure, to ensure that government budgets are aligned with national development objectives.

The importance of being prepared

In many Commonwealth small states, the institutional structure for trade negotiation is very weak and with all its complexity is often left in the hands of a few national officials. At the national level, small states could consider establishing a high-profile council on trade negotiations or organisational equivalent, comprised of representatives of key stakeholder bodies, if these are not already in place (e.g. ministries of revenue, finance, customs, and agriculture, together with the private sector), that has the political mandate to review the progress of trade negotiations and recommend changes in trade positions. The foundation of the trade policy process must be an adequately funded ministry or department in charge of trade negotiations, with the proper mandate and ministerial profile to conduct trade negotiations. Officials within the trade ministry must be provided with adequate technical understanding to guide their stakeholders, recommend positions and seek feedback, as well as adequate resources to represent national positions. Otherwise there remains the risk trade negotiation and policy-making will be conducted in an uninformed manner.

The work of both the national council and trade department/ministry could be based on a written, thoroughly researched, well-publicised and officially-approved national trade policy that clearly spells out economic priorities and their relation to trade outcomes. Without such an analytical basis it will be nearly impossible to determine which trade concessions are economically advantageous and which are not.