ENHANCING EAC INTEGRATION: APPLICATION AND IMPLICATIONS

Peter Allum

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I. Introduction

The commencement of the EAC customs union from January 1 this year has been a significant achievement. But while this marks the end of one process—that of negotiating the agreement itself—it is also the beginning of another: that of implementing the agreement so as to ensure that it yields all participant countries the greatest possible benefit. The Fund and I very much welcome this workshop as a means to the end of ensuring exactly that.

The customs union has implications for a range of policies, relating for example to the development of common trade policies with the rest of the world. There are those, in particular, who see regional trading agreements as a distraction from the more important objective of securing multilateral trade liberalization. Certainly further and deeper trade liberalization should remain a priority for the region, and be factored into future plans.

In these brief remarks, however, I thought it might be helpful to focus on one particular set of issues that we at the Fund see as critical for the EAC coming years: the implications of the customs union for the design and implementation of tax and customs arrangements, and for the continuing process of tax improvement more generally.

II. Challenges for Tax Design

Starting first with tax policy, the customs union poses two main sets of challenges:

The first is that of **dealing with the immediate revenue implications of adopting the common external tariff**. In all three countries, however, the prospective revenue loss appears to be moderate—perhaps around 1 percent of total tax revenue. Current research at the Fund is highlighting the difficulty that many low income countries have had in recovering from domestic sources trade tax revenues lost as a result of trade liberalization. This though has been less the case within the EAC countries than elsewhere. Given too the relatively small amounts involved, this should not be a significant difficulty.

The deeper issue is the **potential need to restructure domestic tax systems to cope with the changed economic circumstances created by the customs union**. The purpose of the customs union, after all, is to encourage the freer movement of commodities and investment between the partner countries. But that also means, to some degree, freer movement of tax bases between them. And as the tax base becomes more mobile within the community, so it becomes harder for each country in isolation to tax that base. This means that each has an incentive to protect its own tax base—and perhaps poach others'—by lowering the tax rate it applies. And that means a risk of mutually damaging tax competition—that is, of a 'race to the bottom' in which failure to coordinate tax polices leaves rates, and revenues, lower than they should be.

What does all this mean in practice? The **first general principle is that problems are most likely to emerge for taxes whose base will become more mobile as a consequence of the customs union**. And here there are two areas of particular concern:

- **Corporate taxation**. With the elimination of internal tariffs, firms will be able to serve the whole EAC by locating in any of the three countries. As they become more footloose in this way, so the incentive for each country to try to attract such investments by offering tax breaks will become stronger. Corporate tax rates are already quite similar across the three countries, but the systems differ quite significantly in the investment allowances and holiday provisions they offer. Experience around the world indicates that tax provisions are rarely the pivotal determinant of companies' location decisions. They always rank low in surveys of companies' attitudes: far below, for example, good governance, productive labor, a supportive infrastructure. And indeed the strong performance of FDI in Uganda following the elimination of tax holidays in 1997 is strongly suggestive of their relative lack of importance. For these reasons, the Fund has always urged the scaling back of such incentives. All those arguments now become even stronger, however, as a consequence of the customs union, because it is likely to intensify the pressures to offer more a more attractive regime than one's neighbor—all, at the end of the day, to everyone's mutual disadvantage.

- **Excise taxation**. While customs controls will remain in place with the Community, the likelihood—indeed the objective—of freer movement of goods is likely to mean easier smuggling and cross-border shopping. Tax differentials can be a powerful motive to such trade (both legal and otherwise), and the effect is always strongest for high-value goods that are relatively easy to transport. That means, in effect, those goods subject to special excise taxes: cigarettes, alcohol, petrol are all, to varying degrees, at risk. Experience in other parts of the world—including the European Union—suggests that the constraints that each country faces in its ability to raise excises by the prospect of encouraging such trade can become a powerful limit to the level of the tax that can be imposed.

In other areas of taxation—the taxation of labor income, and the VAT in particular—the prospective difficulties are not trivial, but they are likely to be less marked.

The next question, of course, is; What can be done about this? And here **the second principle to stress is that while some form of tax coordination may be appropriate, especially in the areas highlighted above, this need not take the form of completely uniform tax systems**. The trick is to devise forms of cooperation that do as little as possible to limit each country's sovereign rights of taxation. Specifically:

- For corporate taxation, one could in principle imagine an EAC-corporate tax, with revenue shared amongst the three countries. But that is not only far from political reality—it is probably also unnecessary. What one could conceive of instead is a non-binding **code of conduct**, by which countries would commit to certain standards of good tax behavior, with violations subject not to formal sanctions but to 'naming and shaming.' The kind of commitments that might be made could include, for example, to transparency, non-discrimination, and the offering only of less damaging kinds of incentive—refraining, for instance, from tax holidays (beyond honoring those already granted). A code of conduct of this broad kind has been implemented, for example, in the EU. The circumstances there are different, of course, from those of the EAC, so that this idea would need considerable work to flesh out both the substantive content and the institutional context. But we offer it as food for thought. One further lesson that some take away from the EU experience is also worth noting. Much time and effort has been spent in the EU on coordinating VAT structures. Arguably the more important task was dealing with corporate taxation. This was left off the agenda for many years, being so politically difficult. It may have been a mistake not to face the problems earlier on.

- **For excises, the key is likely to be agreement not on common levels of taxation but on minimum levels that all will respect**. This is a device that has also been used with some success in the EU. What it would mean, for example, is agreement that the total amount of excise tax on the most popular price category of cigarette in each country would be at least x percent. No doubt it will be difficult to negotiate what exactly x should be. But agreeing a minimum would serve to at least limit how far the downward spiraling of excise tax rates to protect the domestic tax base can go.

Reaching agreements of this kind will not be easy either technically or politically. But it may be easier to do now than later; and later may be too late.

I should note too that I have only highlighted here the policy issues intensified by the customs union. Even in the absence of the EAC customs union, member countries are likely to face pressure on tax revenues from wider trends of continued trade liberalization and downward pressures on corporate tax revenues from international tax competition. There is a need to improve tax policy design irrespective of the customs union. The potential WTO-inconsistency of profit tax exemptions in the free trade zones is one example. Another, and more general, is the need to strengthen the core features of the tax system: the VAT and income tax.

III. Challenges for Revenue Administration

The customs union also poses very practical and immediate issues for tax and customs administration.

Kenya, Tanzania, and Uganda all have customs and tax modernization programs at various stages of development. Implementation of the EAC will have a major impact on all of these programs.

The IMF has provided considerable technical assistance to EAC members to support these revenue modernization programs—11 missions in the last 5 years, not to mention considerable on-going assistance from our East AFRITAC office in Dar es Salaam.

Based on international best practices, a review of the EAC customs union protocol, and a review of each member state's modernization program, the IMF has highlighted a number of key administrative measures that **customs administrations** will need to take to support EAC implementation. These include:

- Harmonization of the customs tariff nomenclature and classification decisions.
- Adoption of a standard system of valuation of goods in accordance with the WTO agreement.
- Implementation of the common external tariff and interim internal tariffs based on common rules of goods origin (including co-operative procedures to verify origin in selected cases).
- Harmonization across the three countries of processes and procedures, including:
  - Harmonization of customs and trade formalities and documentation (including the adoption of a harmonized customs declaration).
  - Implementation of a common transit system.
  - Establishment of common terms and conditions for duty suspension and refund procedures—temporary importation, re-exportation, export promotion schemes, free ports, warehouses, and so on.
  - Co-operation in the prevention, investigation and suppression of customs offences—including mutual assistance, exchange of information, special

surveillance of high risk goods, establishment of common border posts, and appropriate internal and external border control.

- Dissemination of harmonized information to facilitate trade; and adoption of common solutions to problems that restrict trade.
- Establishment of joint customs and trade training programs.
- Production and exchange of standard foreign trade statistics.

- Stakeholder sensitization and education

Just as there are challenges for tax policy in sustaining and improving performance of the wider tax system, so there are wider challenges for **tax administration** too:

- IMF Assistance to the tax administrations of the EAC has focused on putting in place a modernization strategy that will enhance the effectiveness of the administrations, and reduce the costs of compliance to taxpayers.

- A critical first step in tax administration reform is for the EAC members to recognize the contribution that the largest taxpayers make to government revenues. In EAC countries, a small number of taxpayers–typically less than 500, or even fewer—will contribute at least 50 per cent of revenue and often much more. The EAC members are looking to streamline the interactions that these largest taxpayer must make with the tax administration through the establishment of large taxpayer offices (LTOs).

- LTOs will provide full services for large taxpayers—that is, from registration and taxpayer services through to collection enforcement and audit on all tax types, so that large taxpayers only must deal with one small and efficient office.

- In the past it was common for taxpayers to have to deal with separate tax departments that independently administered tax obligations for VAT and income tax. This leads to duplication and extra costs for business. It was possible for a taxpayer to have tax audits from the two departments without any coordination; the rules governing each type of tax were different; taxpayers had to seek information on a tax and register for the particular tax from separate service areas. These costs of doing business are reduced with integrated tax administration.

- The creation of large taxpayer offices by the EAC members is the first step in ensuring that there is integration across the various taxes. Over time the IMF recommends that each of the EAC members moves to integrate all their domestic tax administration within a single department

- A second aspect of the tax administration reforms that the IMF recommends to EAC members is to introduce self assessment of tax obligations. This means that there is much less pre-assessment verification of information in tax returns. The idea is to remove the need for 100 percent checking of all information. Instead there is more risk assessment of taxpayers, with comprehensive audits of the genuinely highest risk taxpayers. This means more effective reviews of taxpayers affairs as well as streamlined processing of tax returns and payments.

- To accompany self assessment, the EAC members are also looking to expand the taxpayer services needed to ensure that taxpayers fully understand their tax obligations. This includes public information and taxpayer rulings to ensure that the largest taxpayers, with complex tax affairs, can have more certainty concerning the application of tax laws.

- For a self assessment regime to be implemented, the tax administration must also have the authority to gain access to information about taxpayers and to impose strong penalties when audits reveal that tax has been understated.

IV. Conclusions

What I have described is a full agenda. Let me conclude by summarizing what I see as the two key lessons that I hope will be pursued further in this workshop and beyond:

- **The customs union poses new challenges, of both policy and administration, dealing with which requires enhanced cooperation between the three countries.** Coordination will have to loom larger on work plans at all levels: from the day-to-day implementation of specific customs transactions to the setting of some broad parameters of tax system.

- **At the same time, the customs union intensifies existing challenges** faced in strengthening and modernizing design and institutions. It is important not to lose sight of the importance of strengthening the core VAT system, for example, even if this an area in which policy coordination is not an immediate priority.

The Fund is of course anxious to do all it can to support progress in these areas, both through AFRITAC-EAST, on the administration side, and by mission from headquarters on policy issues. I look forward to learning more about how we can be of most use. This meeting is indeed a timely one if the customs union is to improve the prospects and circumstances of the region as much as we all hope.