The role of bilateral and regional trade agreements in the modernisation of taxation and revenue policy in developing economies

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Abstract

This paper investigates the impact of existing trade agreements on domestic revenue policy and assesses the potential impact of differing levels of economic integration of domestic policy objectives. The role of bilateral and regional trade agreements is increasingly important given the emergence of the comprehensive trade agreements, such as the current Trans-Pacific Partnership (TPP) negotiations, which seek to have a greater impact on the international trading environment than existing FTAs. In a changing world with rapidly integrating economies, governments are more frequently taking the initiative to reform their trading arrangements through direct negotiation. Given the protracted process of multilateral trade negotiations – as evidenced by the Doha Round – bilateral and regional trade agreements (such as Free Trade Agreements [FTA]) are setting the framework for trade liberalisation in the 21st century. The commencement of the ASEAN Economic Community (AEC) from 2015 demonstrates that emerging economies still see value in further enmeshing their economies into the development of neighbouring economies across the region.

1. Introduction

Over the past twenty years, countries around the world have increasingly embraced trade agreements at both the country-to-country (bilateral) level and amongst (often geographical) groupings of multiple countries (regional level). A Free Trade Agreement (FTA) is a formal undertaking between signatory countries to eliminate or reduce trade barriers, including tariffs and quotas/quantitative restrictions on goods and services traded within the signatory countries.

Developments at a regional level heavily define the present international trading environment. Whilst ongoing uncertainty over the future of Europe has highlighted structural features of the European Union (EU), the Asia-Pacific region continues to work towards enhanced regional integration. The commencement of the ASEAN Economic Community (AEC) from 2015 demonstrates that emerging economies still see value in further enmeshing their economies into the development of neighbouring economies across the region. The AEC continues to be underpinned by the four key characteristics of (1) a single market, (2) a competitive economic region, (3) equitable economic development, and (4) integration into the global economy (ASEAN Secretariat 2012). Additionally, the emergence of the comprehensive Trans-Pacific Partnership (TPP) agreement demonstrates that the current global economic downturn has not inhibited progress towards greater trade liberalisation at a broader Asia-Pacific level.

Bilateral and regional trade agreements (such as FTAs) are a potential avenue for signatory countries to develop and modernise their tax and revenue systems. The liberalisation of tariff barriers through the

phasing down or removal of customs duties is the primary objective of a trade agreement. However, trade agreements also create an opportunity for associated reforms to domestic tax and revenue policies. Growing integration across the ASEAN region, and the goal of TPP negotiators to forge a 'modern and comprehensive 21st century agreement', demonstrate the potential role for regional agreements in driving reform.

The very nature of bilateral and regional trade agreements results in signature countries taking a greater role in shaping the direction of their trade policy. Sovereign nations join together, usually on a regional scale, to create free trade agreements. Member countries belonging to the free trade area trade freely with each other while maintaining trade barriers for non-member countries (Kirkwood 2011).

Trade liberalisation is widely credited for enhancing economic development amongst participating economies. By reducing barriers to trade, countries in the international trading system unlock their economic potential by empowering domestic industries to access foreign markets and strive for greater productivity. Reducing restrictions that are imposed at a government level has the beneficial effect of exposing businesses to international competition and compelling domestic industry to greater innovation and efficiency. Studies have determined that reductions in trade barriers result in benefits to the broader economy. In 2000, a study by the Centre for International Economics (CIE) in Australia found that opening up the Australian economy to greater trade has resulted in the average Australian household being better off by an estimated AUD3,900 per annum (CIE 2000).

Whilst the benefits of reducing the barriers to international trade a well documented, trade liberalisation in isolation is unlikely to deliver optimal economic benefit. Greater trade facilitation alone can only unlock a limited proportion of opportunity as economic wellbeing generated primarily within an economy. The Australian Government's 2011 *Trade Policy Statement*, recently highlighted this point, arguing:

Trade policy and microeconomic policy are as one; the best trade policy is domestic economic reform – a productivity-raising, competitiveness-enhancing microeconomic reform program supported by responsible fiscal policy (DFAT 2011a).

With a growing proliferation of bilateral and regional FTAs, do trade agreements provide a modern and dynamic avenue for countries to undertake necessary economic reform, in parallel with the progressive raising of trade barriers?

2. The growing significance of trade to economic development

As modern commerce increasingly takes place at a global and regional level, businesses require greater certainty when operating within the international trading environment. Globalisation has increased the volume of capital, goods and services that transact across traditional state borders. As the Australian Government's 2008 *Review of Export Policies and Programs* (the Mortimer Review) stated, direct foreign investment has led to an increase in the level of engagement between countries and their economies (Mortimer 2008).

There are considerable advantages resulting from opening up economies to world trade. Global markets offer vast commercial opportunities that in most circumstances far outweigh opportunities that exist within a domestic economy. According to a study conducted in Australia in 2000, it is evident that enhanced trade is directly attributable to higher levels of skills and wages within the domestic economy. As a consequence, Australians working in export industries on average are paid 60 per cent more than other Australian workers in non-trade exposed industries (Pink & Jamieson 2000).

Whilst the benefits of a liberalised trade environment are becoming more evident in developed economies such as Australia, it is important to consider the short and mid to long term impacts of trade liberalisation to developing economies, such as those neighbouring Australia in the Asia-Pacific region.

Following a recommendation from the 2008 Mortimer Review, the Australian Government directed its independent research and advisory body, the Productivity Commission, to undertake a study on the impact of bilateral and regional trade agreements on Australia's trade and investment performance. Amongst other areas, the Commission examined:

- the impact of bilateral and regional trade agreements on trade flows, unilateral reform, behind-the-border barriers, investment returns and productivity growth
- the scope for Australia's bilateral and regional trade agreements to reduce trade and investment barriers or to **promote structural reform and productivity growth in partner countries** (emphasis of this analysis)
- the scope of bilateral and regional trade agreements to evolve over time to deliver further benefits. (Productivity Commission 2010).

The above examination into the scope for trade agreements to promote internal structural reform is central to this analysis. *This research project offers two specific legal case studies in Thailand and Vietnam, as outlined in case studies 1 and 2 below.*

Bilateral and regional trade agreements have become more prevalent across the Asia-Pacific region due to a combination of global factors and factors within the region. In many ways, the 1980s and early 1990s represent the zenith of multilateral trade negotiations. This period saw the negotiation and completion of the heralded 'Uruguay Round' of global trade negotiations, which culminated in the 1994 Marrakesh Agreement which established the World Trade Organization (WTO).

From an international trade law perspective, the Marrakesh Agreement developed out of the *General Agreement on Tariffs and Trade (GATT) 1947*, which was incorporated as an annex into the *WTO Agreement 1994*. The WTO came into force on 1 January 1995, and oversees the international 'rules based' trading system. The WTO Agreement combined the GATT with several other agreements, on such issues as trade in services, sanitary and phytosanitary measures, trade-related aspects of intellectual property and technical barriers to trade. The new agreement also established a new, more efficient and legally binding means of dispute resolution (WTO 1994).

Several Asia-Pacific countries found common ground during multilateral trade negotiations during the 1980s and 1990s. In particular, Indonesia, Malaysia, the Philippines, Australia and New Zealand are all members of the 'Cairns Group' of agricultural producing nations. Established at the height of the Uruguay Round global trade negotiations, the Cairns Group took a common approach to the liberalisation of agricultural trade, and this was significant in developing the Agreement on Agriculture (Cairns Group 2010). This grouping continues to push for the liberalisation of trade in agricultural exports – largely driven by the mutual need to gain greater access to growing export markets.

Following the successful Uruguay Round multilateral negotiation period, global trade talks began to stall after the 1999 WTO Ministerial Meeting in Seattle, USA. The Seattle meeting, hosted by US President Bill Clinton, was marred by violent anti-government street protests and failed to deliver the ministerial declaration needed to get a new round of negotiations under way. Sadly, for proponents of further multilateral trade liberalisation, the Seattle meeting floundered following growing rifts between the United States (US) and the EU, and President Clinton championing the insertion of labour rights in the negotiations, which was the main demand of US trade unions as a mechanism to retain protectionism (Kelly 2009).

The immediate post-Seattle period marked a turning point in regional trade liberalisation across the Asia-Pacific. The failure of the Seattle WTO Ministerial Meeting also had a lasting impact on other countries across the Asia-Pacific region. From late 1999 onwards, Singapore responded by actively seeking regional and bilateral free trade agreements. With a small, highly educated population and minimal agricultural and mining industries, Singapore stood to gain greatly from liberalised flows of trade and

capital. Furthermore, Singapore sought to build on the twin aspects of the Seattle failure and its own preference for liberalised trade, to actively advocate enhancing bilateral and regional trade liberalisation though greater integration of existing trade deals such as the ASEAN Free Trade Area (AFTA) and the Australia-New Zealand Closer Economic Relations (CER) (Pitty 2003).

Since the early 2000s, countries across the Asia-Pacific region have concluded numerous bilateral and regional FTAs, establishing a framework of trade liberalisation that is increasing in its breadth and scope.

The growth in FTAs across the Asia Pacific built on existing trade agreements, including the AFTA concluded in 1992, and the Australia-New Zealand Closer Economic Relations Trade Agreement (ANCERTA) which came into effect in 1983. Key FTAs concluded since 1999 include those outlined in Table 1.

Table 1: Key Free Trade Agreements concluded since 1999

Free Trade Agreement (FTA)	Commencement year
Singapore-Australia FTA (SAFTA)	2003
Thailand-Australia FTA (TAFTA)	2005
Australia-United States FTA (AUSFTA)	2005
ASEAN-Australia-New Zealand FTA (AANZFTA)	2010
New Zealand-China FTA (NZCFTA)	2008
Japan-ASEAN FTA (JAFTA)	2008
ASEAN-China FTA (ACFTA)	2010
ASEAN-India FTA (AIFTA)	2010
EU-Korea FTA (EU-KFTA)	2011

Through the development of these and other FTAs over the past decade, trade barriers across the Asia-Pacific region have progressively fallen, whilst global trade negotiations through the WTO's multilateral Doha Round have largely stalled.

The proliferation of trade agreements across the Asia-Pacific region mirrors the growth of bilateral and regional trade agreements across the world. Whilst the broad strategic objectives of FTAs around the world are often similar, agreements differ considerably in terms of their impact on domestic laws and regulatory frameworks.

3. Developing and implementing a trade agreement

The impact of regional and bilateral trade agreements enacted around the world over the last two decades differs on a case-by-case basis. Some less sophisticated agreements are simply FTAs which involve a reduction in current tariff and non-tariff import controls, so as to liberalise the trade in goods and services between countries. The more sophisticated trade agreements, particularly at the regional level, go beyond traditional trade policy mechanisms, to include regional rules on flows of investment, intellectual property rights, agreements on environmental policies and the free movement of labour (Boston House 2011).

By entering into a trade agreement, member countries choose to adopt a certain level of economic integration. From a minimal integration perspective, a simple FTA offers a loose form of integration, with member countries simply agreeing to remove tariff and non-tariff barriers between them to promote the free trade of goods and services. Many of the bilateral FTAs outlined in the above table are examples of this minimal approach.

Conventional FTAs concluded across the Asia-Pacific over the last decade have effectively taken place as a contract between the negotiating parties. In most circumstances, FTA measures do not require amendments to domestic legislation. Signatory parties generally implement key adjustments to the bilateral/regional trading arrangements, such as adjustments to tariff schedules, by direct gazettal. In some countries international agreements and treaties require the ratification of the national parliament/assembly before they can take effect. For example, in Australia, irrespective of whether proposed final trade deals require legislation, they are subjected to parliamentary scrutiny before the Parliament's Joint Standing Committee on Treaties (DFAT 2011a).

As trade agreements become more sophisticated, signatory countries take on board additional undertakings to reform and harmonise the application of domestic legislative and regulatory functions, including:

- the setting of common external tariffs
- the mobility of assets
- harmonised economic and monetary policy.

Table 2 outlines a scale of economic integration, ranging from a minimal free trade area through to a comprehensive economic union, which encompasses the comprehensive levels of integration outlined above. Regional groupings, such as ASEAN, which are moving towards greater economic integration through the AEC 2015 should note the opportunities and challenges posed by each stage.

Table 2: Level of economic integration by grouping/union type

Stage of Economic Integration	No Internal Trade Barriers	Common External Tariff	Factor & Asset Mobility	Common Currency	Common Economic Policy
1. Free Trade Area	X				
2. Customs Union	X	X			
3. Single Market	X	X	X		
4. Monetary Union	X	X	X	X	
5. Economic Union	X	X	X	X	X

Note: Table 2 draws on an analysis undertaken by Boston House (2011).

This table demonstrates the significance of progressing from phases one and two to phase three, where signatory states are required to make legislative or regulatory changes beyond simply adjusting tariff and other trade barriers. This analysis is particularly relevant when assessing the economic crises impacting the EU throughout 2011 and 2012. As a Monetary Union, but not a full Economic Union with common economic policies, Eurozone economies have the inflexibility of a common currency, without a common approach to policy to underpin the long term economic direction of the grouping.

As bilateral and regional trade agreements continue to proliferate, a more comprehensive analysis of what members seek to gain from greater trade integration is required. In particular, greater consideration of the role of trade agreements in the modernisation of taxation and revenue systems could add additional value to the integration process. As countries seek to enter into comprehensive regional trade agreements, such as the TPP Agreement, trade negotiators in partnership with their domestic stakeholders are contemplating how modern agreements can seek to address multiple policy aims. Formal consultation processes provide an opportunity for countries to consider non-tariff reforms within their domestic economy that can impact ongoing international trade with signatory parties.

4. The direct impacts of trade agreements in the Asia-Pacific region

Australia provides a useful case study of the importance of enhancing international trade arrangements. Australia has greatly increased its trade with neighbouring Asian countries over recent decades. Australia's trade with North-East Asia (including China, Hong Kong, Japan, the Republic of Korea and Taiwan) increased from 25 per cent of Australia's total exports in 1965, to 44.6 per cent of Australia's total exports by the time of the establishment of the WTO in 1995. Additionally, the proportion of Australia's total exports going into South-East Asia grew from 4.3 per cent to 15.9 per cent over this period (Smith 2001).

The slowing of multilateral trade negotiations since the conclusion of the Uruguay Round has shifted focus to direct trade agreements. Given the growing importance of regional trade, Australia sought to enhance its market access into the region with a broad FTA with the members of the Association of South East Asian Nations (ASEAN). In 2009 Australia, together with New Zealand, concluded the ASEAN-Australia-New Zealand FTA (AANZFTA). Coming into force in 2010, AANZFTA is the biggest FTA that Australia has concluded, with ASEAN and New Zealand together accounting for 20 per cent of Australia's total trade in goods and services. Worth AUD112 billion in 2008, this was larger than Australia's trade with any single country (DFAT 2011b).

An often overlooked aspect of many free trade agreements is that they require signatory countries to make only limited amendments to domestic legislation. Most of the changes resulting from the AANZFTA were enacted through simple changes to tariff schedules or other non-legislative means. Table 3 below maps the key chapters within the AANZFTA against requirements for legislative amendments.

Table 3: Impact of a Free Trade Agreement on domestic legislation

AANZTFA – Table of Contents		
FTA Chapter	**Issue**	**Change to domestic legislation?**
Chapter 1	Establishment of Free Trade Area, Objectives and General Definitions?	NO (Overview of definitions in the agreement)
Chapter 2	Trade in Goods	NO (Provision for schedule of tariff reduction commitments and reassertion of obligations under *WTO/GATT Agreement 1994*)
Chapter 3	Rules of Origin	NO (Overview of definitions and formulas used in the agreement)
Chapter 4	Customs procedures	NO (Provisions in the chapter are broad, with references to general obligations [e.g. encouraging parties to consult], but limited prescription for customs procedures)
Chapter 5	Sanitary and Phytosanitary Measures	NO (Text of this agreement affirms commitment to WTO SPS Agreement and trade facilitation measures between signatory parties.)
Chapter 6	Standards, Technical Regulations and Conformity Assessment Procedures	NO (However, this chapter commits signatory parties to consider accepting technical regulations of other parties. This may require some regulatory or legislative amendment.)
Chapter 7	Safeguard Measures	NO (Affirms signatory parties to global safeguard provisions under Article XIX of the GATT 1994 and definitions for enforcing safeguard measures.)

AANZTFA – Table of Contents		
FTA Chapter	**Issue**	**Change to domestic legislation?**
Chapter 8	Trade in Services • Financial services • Telecommunications	POSSIBLY (Depending on the internal prudential regulations, signatory parties may need to adjust foreign investment restrictions in the banking and financial services industry. Additionally, telecommunications industries are tightly regulated in many signatory markets, and individual domestic legislation is referenced in the text of the *Annex on Telecommunications*.)
Chapter 9	Movement of natural persons	NO (Affirms signatory parties to grant temporary Visa entry to natural persons of other parties to facilitate fee commerce amongst member borders.)
Chapter 10	Electronic Commerce	**YES POSSIBLY** **(Article 4 of Chapter 10 calls for each party to maintain, or adopt as soon as practicable, domestic laws and regulations governing electronic transactions taking into account the *UNCITRAL Model Law on Electronic Commerce 1996*. Legislative amendment is only required where this model law has not yet been adopted.)**
Chapter 11	Investment • Annex on Expropriation & Compensation	NO (Text of Chapter 11 takes into consideration domestic definitions of investment.)
Chapter 12	Economic Cooperation	NO (Acknowledges the need for further economic cooperation and sets broad framework for individual cooperation activities.)
Chapter 13	Intellectual Property	**YES** **(Article 6 of Chapter 13 requires signatory parties to 'maintain appropriate laws, regulations or policies that make provision for its central government agencies to continue to use only legitimate computer software in a manner authorised by law and consistent with this Chapter'.)** *NOTE: The Australia-United States Free Trade Agreement required domestic legislation in Australia regarding Effective Technical Measures for media copyright laws and the administration of Australia's Pharmaceutical Benefits Scheme* (DFAT 2011c; DoHA 2008).
Chapter 14	Competition	NO (Chapter 14 provides a framework for cooperation activities.)
Chapter 15	General Provisions and Exceptions	NO (Article 3 of Chapter 15 specifically states that the Agreement has only limited prescription to taxation measures – not including customs tariffs.)
Chapter 16	Institutional Provisions	NO (Provides framework for ongoing administration and review of the agreement.)
Chapter 17	Consultations and Dispute Settlement	NO (Sets the terms, scope and coverage of the dispute settlement process.)
Chapter 18	Final Provisions	NO

Source: AANZFTA 2010.

As Table 3 demonstrates, a 'minimalist' FTA such as the AANZFTA is essentially a contractual agreement between the signatory parties to reduce tariff-based and non-tariff-based barriers to trade. This FTA does not prescribe a considerable level of economic integration between the signatory parties beyond the removal of tariff barriers. As such, only limited amendments to domestic legislation are required to enact the agreement.

A key difference between a 'minimalist' trade agreement and a more comprehensive agreement, such as a single market or an economic union, is the requirement for signatory countries to adopt measures that require amendment to or modification of domestic laws. Keeping domestic legislative changes to a minimum removes potential obstacles to the adaptation of a trade agreement as legislative amendments often result in political resistance, particularly where the short-term interests of domestic industry and government revenues are involved.

5. Immediate costs and benefits from trade agreements

A potentially unforeseen consequence of trade liberalisation is the impact of customs tariff reductions on domestic tax bases, and therefore on domestic tax collections. Whilst trade is likely to stimulate further economic activity, government treasuries and finance ministries are nevertheless concerned about the impact to indirect tax revenues. This is particularly the case with narrow-based indirect taxes such as excises, also known as 'special consumption taxes' or similar titles.

The broad perception of free trade agreements across a broad regional grouping such as the AANZFTA signatory countries is likely to vary greatly depending on specific economic circumstances of the particular country. For more developed countries, such as Australia or New Zealand, trade agreements are broadly regarded as positive developments that will lead to greater prosperity as a result of a greater flow of trade across signatory countries. For example, the Australian Government publicly supports the benefits of bilateral and regional FTAs, despite the current government's strong statements that the Doha Round of multilateral trade negotiations remains Australia's number one trade reform priority.

In developing economies, there is likely to be a greater degree of debate regarding the overall costs and benefits of trade agreements. Whilst developed economies have broad, diverse and mature industries across a wide range of goods and services sectors, developing economies often have a narrower base of established industries. Furthermore, developing economies are often more likely to have higher levels of existing protection than developed economies, for example, higher Most Favoured Nation (MFN) Customs Duties (Ali 2011)

Table 4 below demonstrates the diverging MFN Customs Duties on one example of a good which is levied an excise once in the domestic market: alcohol beverages. The table demonstrates different rates in select AANZFTA member countries.

Table 4: Divergent domestic excise rates in different countries within the AANZFA

Country	MNF Customs Duty on alcohol beverages	
Australia	Beer	0%
	Wine	5%
	Spirits	5%
Thailand	Beer	60%
	Wine	54% or 60%
	Spirits	60%

Country	MNF Customs Duty on alcohol beverages	
Vietnam	Beer	35%
	Wine *(still and sparkling grape wine)*	50%
	Spirits *(whisky, gin, vodka)*	48%
Cambodia	Beer	35%
	Wine	35%
	Spirits	35%

Source: Customs Tariff Working Pages, current as of July 2012.

6. Impacts of FTAs on government indirect tax revenue

From an excise taxation perspective, this analysis highlights the impact of trade agreements on the internal tax treatment of alcohol beverages. Alcohol is an effective case study as it is a key excisable commodity, which is classified as a 'narrow based' indirect tax. Governments levy excise on alcohol. The Organisation for Economic Co-operation and Development (OECD) classifies excise taxes as: '... taxes levied on particular products or on a limited range of products', and qualifies this by stating that 'they may be imposed at any stage of production or distribution and are usually assessed by reference to the weight or strength or quantity of the product', but sometimes by reference to value (OECD 2004, 5121).

Governments levy excise on certain products for two main reasons. Firstly, governments seek to recover the negative external cost to the community of the consumption of certain commodities, such as alcohol, tobacco and petroleum. Secondly, excisable products often have a low price elasticity. As a result, in practice, most countries have enacted excises for revenue purposes, regardless of consumption concerns, as they represent a stable revenue base (Cnossen 2005).

This international definition of excise taxation is important as it demonstrates differing policy priorities between different governments regarding excise taxation. In developed economies, excise taxes account for less than 10 per cent of total government revenues. For example, in Australia revenue from alcohol, tobacco and petroleum products accounted for 7.5 per cent of total taxation revenues in the 2008-09 financial year (Australian Government, Department of the Treasury 2010). In contrast, this proportion is far greater in developing economies, for example, in Thailand excise revenues generally account for approximately 25 per cent of total government revenue (Chandevwit & Dahlby 2007). In considerably under-developed economies, such as Cambodia, excise revenues account for approximately 46.3 per cent of total government revenues (Cnossen 2011).

Table 5: Government revenue from customs and excise taxes

Level of economic development	Country	Proportion of government revenue from customs and excise taxes, 2008
Developed economy	Singapore	17.3%
Developing economy	Thailand	33.9%
Under-developed economy	Cambodia	46.3%

Source: IMF 2008 data; Cnossen 2011.

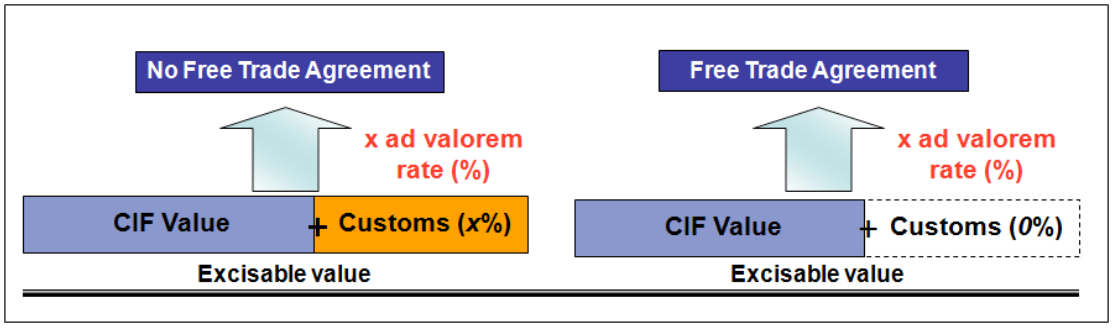
As Table 5 demonstrates, developing countries have a greater reliance on narrow-based excise taxes. Excise taxation is an internal taxation measure levied on both domestically produced and imported products.

Linkage between customs duties and excise revenue

However, in many developing countries, including Thailand and Cambodia, alcohol excise is levied through an ad valorem (or value-based) method, in which customs duty paid forms a component of the excisable base of the product. As a result, falling customs duty rates through tariff reduction commitments directly impact excise tax bases. Presently, FTAs across the Asia-Pacific region do not prescribe reforms to internal taxes such as excise; rather the focus is on the reduction or removal of customs duties.

With FTAs progressively decreasing and then eliminating applied customs duties on alcohol beverages, signatory countries are faced with the dual impact of falling customs revenues and excise revenues with the shrinking of taxable base values used for calculating ad valorem excise liabilities. The graphic below demonstrates the impact of a reduction in customs duties on an excisable base value.

Box 1: The impact of reduced customs duties on ad valorem excise base values



Source: Obradovic 2012.

Addressing falling customs and excise duties is an increasingly relevant issue across the Asia-Pacific. In particular, 2010 saw applied customs duties in Thailand under three key FTAs – the AFTA, the China-ASEAN Free Trade Agreement (CAFTA) and the Thailand-Australia Free Trade Agreement (TAFTA) make their final phased reduction down to 0 per cent.

Whilst governments, in particular their customs agencies, factor in the impact of falling customs duty revenues when negotiating trade agreements, this is not necessarily the case with other revenue agencies.

The following case studies in Thailand and Vietnam are two contemporary examples where developing economies have proposed amendments to domestic laws or regulations to offset the short-term impacts of trade liberalisation.

7. Case study 1: Thailand 2009 – the impact of free trade on internal excise taxation

2010 represented a watershed for trade liberalisation in the Asia-Pacific, with many commodities subject to phased tariff reductions undergoing their final transition phase down to 0 per cent. In the case of alcohol beverages in Thailand, beverages originating from signatory countries to the AFTA, CAFTA) and TAFTA reduced from 5 per cent to 0 per cent on 1 January 2010.

Beer products in Thailand are predominantly levied an ad valorem alcohol excise (known as the 'Liquor Tax'). As 2010 approached, some policymakers in Thailand were concerned about the impact of shrinking excise base values for imported alcohol products that had traditionally been levied a customs duty. Furthermore, the looming removal of the final 5 per cent of customs duties aroused some local

concern regarding the potential impact of a 'flood' of cheap imports, especially beer, from less developed countries within ASEAN and China.

In an effort to offset the impact of the removal of the final customs tariff amount, several reform proposals emerged to amend Thailand's *Liquor Act B.E 2493 (1950)* (the Liquor Act). Of particular significance was a proposal to roll back the FTA reductions in customs duties, and reinstitute MFN tariff rates for the purposes of calculating ad valorem tax bases.

Below is an unofficial translation of the key section of one proposed amendment to the Liquor Act. In bold is a contentious proposal on the application of customs duties in ad valorem excise bases, as well as a proposal to grant arbitrary powers for the determination of the excisable base value in the event of a disputed Cost + Insurance + Freight (CIF) price.

> *Section 8 quarter Ad valorem liquor tax shall be imposed according to the value of liquor set out under (1) (2) and (3) which shall include payable liquor tax as follows:*
>
> *(1) In respect of liquor made in the Kingdom, the tax shall be based on ex-factory price.*
>
> *(2) In respect of imported liquor, the CIF price of the liquor plus import duty, special fees under the law governing investment promotion and other taxes and fees to be determined by a royal decree shall apply, but excluding the value added tax as prescribed under Chapter IV, Division 2 of the Revenue Code.*
>
> *CIF price under the first paragraph is the price of liquor plus insurance and freight at the customs house in the Kingdom unless, where the customs officials re-assess the price for imposition of import duty under the law governing customs, such price shall be the liquor price for the purpose of calculation of CIF.*
>
> ***Where the import duty is waived or discounted under the law governing investment promotion or is waived or discounted to the rates which are lower than the normal rates applicable in general with other countries, such waived or discounted import duty shall be included as a basis for calculation of the value under the first paragraph.***
>
> *(3) In respect of liquor produced in Customs Free Zone or Export Processing Zone, the tax shall be based on the ex-factory price if being used for other purposes than export.*
>
> ***In the case there is no price under paragraph 1 (1) (2) and (3) or there are multiple prices or the selling prices applied are not the selling prices of the [unrelated] parties, the Director-General, by an approval of the Minister, shall have the power to announce the liquor price for tax calculation basis****, provided that the calculation methods applied are those that have been certified internally and shall be made in pursuant to the rules, procedures and conditions as stipulated in the Ministerial Regulation (Proposed amendment to the Liquor Act B.E 2493 (1950), unofficial English translation 2009).*

In application, the proposal to reinstate MFN customs duty amounts into the excise tax base would result in a scenario where reduced customs duty rates would not flow through the supply chain to apply to ad valorem internal taxes, such as excises.

Additionally, paragraph 3 of the draft liquor amendment proposed granting additional discretion to the Excise Department (through its Director-General) to unilaterally set disputed CIF prices when determining the excise base value of the product. Thailand had previously faced the threat of a formal trade dispute in 2008 and 2009 regarding the discretionary setting of import values, including alternative

customs valuation methods for imported goods including distilled spirits beverages (United States Trade Representative 2010).

Since this dispute, the Philippines have successfully challenged Thailand's arbitrary customs valuation practices, with the WTO Dispute Settlement Panel in *DS371: Thailand – Customs and Fiscal Measures on Cigarettes from the Philippines* finding that Thailand's Customs Valuation Procedures are inconsistent with Thailand's obligations under the WTO Customs Valuation Agreement (WTO DS371 2011).

Thailand's Liquor Act proposal met firm resistance from industry and representatives of the international community, including the EU. At the time of writing this paper, Thailand was yet to enact any of the aforementioned reforms to the Liquor Act, and there do not appear to be public indications that such a reform is currently under consideration.

A possible role of bilateral and regional trade agreements?

This proposal demonstrates a disconnect between bilateral and regional trade agreements and domestic taxes that are directly impacted by the reduction in ad valorem tax bases. Through preparing this draft Liquor Act amendment, the Excise Department, in effect, argued a case to recoup revenues lost due to its shrinking taxable base values.

This amendment highlights the fact that a minimalist FTA does not prescribe reform options to modernise the excise taxation system in Thailand. The impact of the tariff reductions on Excise Department revenue demonstrates the inherent instability of Thailand's narrow-based indirect tax systems, in particular the reliance on ad valorem excise systems that require the establishment of import prices, and result in price inter-dependencies running through the supply chain.

Many key stakeholders within industry, government and the health lobby advocate 'volumetric' excise methodologies, where the rate is determined according to the volume or certain characteristics of the excisable product. Many within the alcohol industry support volumetric taxation as it creates certainty regarding excise tax liabilities, as alcohol strength and product classification – not price – are the determining factors. Health and social policy advocates support volumetric tax due to its fundamental link between the tax levied and the volume of the product of which the tax seeks to discourage or regulate consumption (Due 1994).

The EU has, since 1992, required its signatory members to adhere to a series of criteria regarding the structure and rates of their internal alcohol excise systems. These measures, which are outlined in Directive 92/84/EEC and Directive 92/83/EEC, prescribe a volumetric alcohol excise regime as a condition of EU membership. EU members retain the flexibility in how each party sets their actual volumetric excise rate, and/or delivers rebates for consumption within that member's borders (EU 1992).

Aside from the health and social policy elements of volumetric excises on alcohol beverages, the EU's prescribed alcohol excise regime ensures that there is a complete de-coupling of the customs and excise taxation systems. This is important from a tax policy planning perspective, as it enables a more modern approach where each system can focus on their primary policy objectives.

8. Case study 2: Vietnam 2011 – proposed changes to import regulations

The second (minor) case study in this analysis concerns a series of non-tariff proposals put forward by two Vietnam Government departments: the Ministry of Finance (MoF) and the Ministry of Industry and Trade (MoIT). These proposals have imposed additional restrictions on the trade of certain goods into Vietnam. In contrast to the main case study in Thailand, the proposals from the MoF and the MoIT are

not directly related to the implementation of a bilateral or regional trade agreement, rather they are in response to general concerns regarding Vietnam's trade position.

The MoIT and MoF suite of proposals were announced in April 2011 in response to a commitment by Vietnam's Prime Minister to keep the country's trade deficit below 15 per cent in 2011. The MoIT initiated the series of measures by identifying 100 different imported commodities for special import restrictions to temporarily restrict the trade deficit. One of the products nominated for this list is distilled spirits beverages. The MoF proceeded to assist the MoIT proposals by developing proposal number *4629/BTC-TCHQ*.

This document proposed the following measures to enact a temporary restriction on imports of the selected commodities:

1. restricting the importation of alcohol products to only three ports in Vietnam
2. increasing the customs duties rate to the maximum MFN rate permitted under Vietnam's WTO commitments
3. longer import processing timeframes
4. movement of goods restrictions
5. pre-export labelling
6. tightened import, wholesale and retail regulation
7. investigating increases to alcohol excise rates (Vietnam MoF 2011).

Whilst the MoF/MoIT proposals were not made in the direct context of Vietnam's commitments under its various bilateral and regional trade agreements, it is important that the proposals are taken into consideration when assessing Vietnam's commitment to trade liberalisation. The seven measures outlined above propose six non-tariff barriers to trade, and one additional tariff barrier (measure number 2). As a result, Vietnam's trading partners were notified of the measures under the terms of the WTO's Agreement on Technical Barriers to Trade (TBT) and the TBT Committee process.

The proposal in measure 2 to increase customs duties to the maximum allowable MFN rate runs the risk of Vietnam rescinding its tariff reduction commitments under its existing FTAs, including AFTA, AANZFTA, CAFTA and the ASEAN-India FTA. Whilst other measures within the MoF/MoIT proposals are broadly covered in the text of minimalist FTAs, such FTAs only provide for a contractual arrangement between signatory parties and do not offer international best practice guidelines as an alternative to reactionary policymaking.

The Vietnam MoF/MoIT proposals raise several international trade law issues. While this article does not provide a detailed critique of individual policy measures against international trade law principles, it is worth briefly highlighting where policymaking in emerging economies can run the risk of breaching international trade law if there is a potential lack in best-practice policy. Initial analysis of these measures indicates that, if challenged, Vietnam could be in breach of several WTO obligations, including the Agreement on Sanitary and Phytosanitary Measures (the SPS Agreement) and Articles of the GATT 1994.

A possible role of bilateral and regional trade agreements?

As outlined with respect to the proposals in Thailand, bilateral and regional trade agreements provide an opportunity to prescribe international best practice policy to assist emerging economies in their modernisation process.

In particular, incorporating best practice regulation into bilateral and regional trade agreements can help to steer emerging economies away from policy proposals that risk breaching their international trade law commitments, as well as their direct obligations under the trade agreement itself. With the development

of modern trade agreements, such as the current TPP negotiations, trade negotiators and stakeholders are looking for ways to enhance their country's trade interests. The text of modern agreements provides a potential avenue for an era of expanded trade policy enhancements, with trade negotiators considering the inclusion of specific annexes that deal with specific tariff or non-tariff issues that impact the trade of goods under the terms of the agreement.

9. Developing a revenue modernisation 'framework'

The very fact that a bilateral or regional FTA constitutes a contract between the signatory countries summarises the dynamic of the argument around modernising tax and revenue policies. From one perspective, if a trade agreement is a contract, rather than a comprehensive review of policies, direct trade agreements are primarily focused on streamlining current systems and are not designed to be overtly prescriptive in their policy intent. However, an alternative view could argue that by entering into a direct trade agreement, signatory countries are taking a proactive step, ahead of global pace, to modernise their trade environment.

Trade agreements can bring forth unintended consequences, with government indirect tax revenue bases along the supply chain for imported goods dependent on customs duties. Modern, comprehensive trade agreements afford the opportunity for signatory parties to consider legislative or regulatory reforms that can further-modernise domestic tax and revenue policies.

The AANZFTA stipulates that signatory countries should maintain, or adopt as soon as practicable, domestic laws and regulations governing electronic transactions taking into account the *UNCITRAL Model Law on Electronic Commerce 1996*. This provides a tangible example of how a trade agreement can provide a contractual avenue for the development and implementation of international best practice law or guidelines. In particular, this represents an area of policy, or a default option in which countries can amend domestic legislative requirements to ensure that complementary legislation is in place to ensure that the trade liberalisation process meets its objectives.

Another initiative open to modern trade agreements is the potential to enshrine international best practice, as it has been developed and is enshrined within either the WTO Agreement 1994, its annexes, and other international trade and customs conventions. In terms of tax and revenue policy however, the link between internationally recognised 'model laws' or guidelines and international trade agreements is not as explicit. In developing and implementing 'model laws' or guidelines for implementation into bilateral or regional trade agreements, negotiating parties can consider precedents that exist from two distinct categories:

1. measures or directives for existing comprehensive groupings (for example, Single Market or Monetary Union), or
2. model laws or guidelines developed by authoritative international agencies (for example, IMF, World Bank or OECD).

Measures such as those in the example below, EU directives could be applicable to bilateral trade agreements, however they could be particularly relevant for regional trade groupings where geographical and geopolitical interests additionally define membership (Chandra 2005). This includes the ASEAN grouping of countries, and to a lesser degree the Asia-Pacific Economic Cooperation (APEC). In contrast to the EU, other regional groupings of developing economies, such as the Southern Africa Development Community and the East Africa Community do not mandate excise taxation structures. However, these groupings have committed to some degree of excise and VAT harmonisation or coordination amongst member countries.

Box 2: Example: EU and alcohol excise taxation

As outlined earlier in this article, EU member countries are required to ensure that their domestic laws adhere to the requirement that they are levied under a volumetric alcohol excise system. Whilst individual EU member countries retain the right to set different excise rates to one another, including rebates on domestic consumption, EU membership carries with it a requirement to adopt the volumetric alcohol tax methodology.

Whilst this in itself may be a controversial case study, given the health, social, religious and domestic industry sensitivities to imported alcohol beverages, the principles underpinned by a common taxation methodology are features of a modern and transparent tax and revenue system. The principles underpinned by Directives 92/84/EEC and 92/83/EEC and similar requirements for the tax treatment of other commodities across the EU could help to assist with the drafting of more comprehensive trade agreements into the future.

In addition to comprehensive international groupings, recognised international agencies, in particular the International Monetary Fund (IMF), the World Bank and the OECD are a good source of thought-leadership regarding drafting tax and revenue policies. At the macroeconomic level, many economic theorists and practitioners agree that fiscal transparency has large and positive effects on the fiscal performance of governments. In 1998, economists Kopits and Craig observed that:

> Transparency in government operations is an important precondition for macroeconomic fiscal sustainability, good governance, and overall fiscal rectitude (Kopits & Craig 1998).

By entrenching transparency into the drafting of internal tax and revenue laws, governments ensure that they open their legislative processes to the scrutiny of key stakeholders within the economy.

For the purpose of this analysis, below are two examples. One is a relevant IMF guideline and the other is a relevant set of OECD principles.

Box 3: Example: IMF suggested guidelines on tax law design and drafting

In 1996 the IMF published its suggested guidelines on the drafting of tax and revenue laws. The IMF released this publication based on the IMF Legal Department's experience in assisting many developing and transition countries with the drafting of tax legislation.

The guidelines distil from the IMF's experience into a set of practical guidelines for officials and their advisers. The guidelines cover international best practice in key areas including:

- the tax legislative process
- the legal framework for taxation
- drafting tax legislation
- law of tax administration and procedure.

One useful example where an OECD guideline is recognised as international best practice is in the area of transfer pricing. Transfer pricing is an intercompany pricing methodology used by multinational companies to determine prices for related party transactions, with this methodology providing guidance for tax administrations in determining tax liabilities when related parties transact with each other across customs borders.

Box 4: Example: OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

According to the OECD, the transfer pricing principles set clear and transparent rules regarding international commerce and cross-border transactions:

> In a global economy where multinational enterprises (MNEs) play a prominent role, governments need to ensure that the taxable profits of MNEs are not artificially shifted out of their jurisdiction and that the tax base reported by MNEs in their country reflects the economic activity undertaken therein. For taxpayers, it is essential to limit the risks of economic double taxation that may result from a dispute between two countries on the determination of the arm's length remuneration for their cross-border transactions with associated enterprises (OECD 2010).

A considerable amount of thinking has gone into whether the OECD guidelines can provide a framework for customs authorities to determine the import cost of a good in the case of a dispute over the declared transaction value.

The actual applicability of international best practice, such as the IMF Guidelines or the OECD Principles, require detailed analysis and are sure to engender considerable debate. Studies such as a recent *Asia-Pacific Tax Forum* research project on the relationship between transfer pricing, customs valuation and excise tax bases encourage international dialogue on the possible role of international best practice principles to trade liberalisation. The contractual nature of trade agreements, and the level of negotiation involved in developing a bilateral or regional trade agreement provides an avenue for the consideration of international best practice principles for ensuring a quality and sustainable outcome for signatory parties.

10. Conclusions

The current international trade and economic climate could create the environment for a range of enhanced bilateral and regional trade agreements. Whilst EU member countries seeking methods in which to move forward from current problems relating to the complex and comprehensive EU common market, ASEAN member countries are looking for ways to further enhance regional integration in the lead up to the AEC in 2015.

AEC integration will be an ongoing process between ASEAN parties, however in parallel to this process, modern bilateral and regional trade agreements across the Asia-Pacific, such as the TPP, develop trade policy reform frameworks that can assist countries across the region with the reform process. The contractual nature of trade agreements and the level of negotiation and consultation involved in developing a bilateral or regional trade agreement provides an avenue for the consideration of international best practice principles for ensuring a quality and sustainable outcome for signatory parties.

As the trade liberalisation paradigm shifts from the multilateral trade negotiation arena to a growing network of bilateral and regional trade agreements, new trade agreements offer an avenue to assist emerging economies modernise their tax and revenue systems. As the Thailand case study demonstrates, the immediate impact of falling tariff barriers can cause revenue authorities to take short-term focused measures that are contrary to developing a more open and transparent system that creates certainty for foreign investment.

Parties to contemporary trade agreements state the importance of the agreement being as comprehensive and as high quality as possible. As the recent Australian Policy Statement highlighted, 'low-quality free trade agreements are free in name only; they lock in and legitimise the protection of each country's market from competition from the others' (DFAT 2011a).

The AEC 2015 is intended to be bold and comprehensive, and as a result it will stand to gain a great deal more through similarities with modern and comprehensive regional trade agreements, as is the intention of the TPP, than from basic, low quality agreements that seek limited commitments from their signatories.

Trade agreements afford the opportunity to encourage further reform and transparency within domestic tax and revenue systems. Given the growing proliferation of trade agreements, it is important that new agreements unlock their potential to achieve greater commitments from signatory parties to enact positive and constructive reform.

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Note

1 The views and opinions expressed in this paper are those of the author and do not necessarily represent the views and opinions of KPMG, an Australian partnership, part of the KPMG International network.

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