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A Constructive Proposal for the Redistribution of Fiscal Resources within an East African Customs Union.

A. The problem.

1. At the moment the customs revenues generated by the imports of the three territories are distributed in such a fashion that the amount of revenue received by each territory is an increasing function of its imports. (As a result of the Raisman Commission this relationship is not strictly proportional).

2. Within a unitary state the use of such revenues to finance government services would not be dependant on the regional contribution to the import bill. For example, no such relationship exists within each territory as regards its allocation of spending between the various districts.

3. Under the existing arrangements the more advanced territory benefits twice over:

(a) it will have the greatest amount of industry receiving protection;

(b) because of its higher degree of development it will have a larger import bill and will therefore receive a greater share of the customs revenues.

Such is the current situation of Kenya.

4. The less developed territories (i.e. more primary product producing) will gain little fiscal benefit from export trade unless they, themselves, tax exports, which may have an undesirable disincentive effect on exports.

5. The less developed territories may feel that they, through their export surpluses, are financing the import bill of the more developed territory when these very imports are the means of increasing the gap between the territories. This may happen both because of the financial flows created through the sale of goods and services of the more developed territory to the less developed territory and because of capital movements within the common currency area, which may flow towards the more developed sections. Therefore the danger exists that the gap within the region as a whole will widen in much the same way as the gap between the rich and the poor nations is widening in the world at large.

6. In this situation the less developed territories will seek to redress the balance, probably by breaking up the common arrangements, so as to protect their own industries and to control capital movements. Alternatively, it might be possible to take the step towards a fully unitary state which would provide an adequate political mechanism for fiscal redistribution, probably through the equalization of services.

7. If the latter alternative proves impracticable it will be necessary to devise means of meeting the desires of the less developed region for steps towards equaliztion, if the common arrangements are to be retained. However, the more developed territory will be resistant to fiscal redistribution not because of unthinking selfishness, but because the higher level of development achieved demands more expensive government services and therefore the fiscal problem they face in financing their budget is likely to be chronically serious.

8. On the other hand, non-fiscal techniques for equalization (e.g. the location of industry to the less developed areas) may be quite difficult to handle, insofar as most industrial investment is private and the planning mechanism is in its infancy.

9. Therefore it seems likely that if the common institutions are to survive either a substantially unitary state must be established (i.e. a "strong" rather than a "weak" federation) or a fiscal redistribution mechanism must be set up despite its budgetary consequences for the more developed territory. (In a region with such desperately low income levels, the term "more developed" is entirely relative.) If the latter course is adopted the less developed territory can use the additional resources to raise the level of its services and to finance additional investment.

The proposal.

10. The proposal offered here is that the revenues from customs and excise should be allocated between the territories according to their share in total exports.

11. Such a plan would be quite simple to operate. At the outset the changeover could be made gradually. Having been established, such a system would redistribute resources to the less developed territories (with their large quantities of primary exports and low foreign import bill). But as these territories develop their share in the foreign import bill will rise and the difference between the allocation uder the suggested schme and the existing arrangements would narrow.

12. In effect, such a scheme could be viewed as a tax on the consumer in the more developed territory paid in recompense for continued free access to the markets of the l less developed territory. It has the virtue that the fiscal redistribution will automatically diminish as the less developed territory catches up. The fiscal transfer would automatically cease when the territories are importing from abroad in the same proportion as they are exporting, at which point the flow of inter-territorial trade (both visible and invisible) and of capital should be in balance. An additional result of the proposal would be to reduce a potential conflict of interest: it would be in the developed economy's interest to increase customs rates for protection purposes and in the less developed territory's interest to do so for revenue purposes.

13. This proposal will not be popular in the more developed territory, but as that territory obtains a major part of the current advantage of the existense of the larger market provided by the common arrangememts, it must expect to bear a large part of the cost of their maintenance.

14. This form of allocation would have the interesting side effect that it would provide a fiscal reward for increasing exports (a desirable thing in a situation where foreign exchange is likely to be a serious constraint on development), unlike the present system, which provides a fiscal reward for increasing imports.

The impact of the proposal.

15. The table on the following page shows the effect of the suggested system on the distribution of revenues. Whether the redistribution is commensurate with the distribution of current benefits from the common market is difficult to judge. It is not even possible to measure inter-territorial transactions with accuracy, both because of the difficulties of measuring the inter-territorial trade in "invisibles" and because of the lack of data regarding inter-territorial capital movements. Even if these transactions were known the net effect of the common institutions would be difficult to judge because of a number of conflicting effects:

a) some part of the trade in both visibles and invisibles would continue even if the current arrangements ended;

b) the end of the common market would result in a loss of future market opportunities far in excess of current trade;

c) there would be multiplier effects of the reduction in trade both because of the reduction in demand resulting from unemployment and because a marginal loss in business might lead to the complete collapse of some enterprises (so that the alternative might also have severe budgetary effects in the more

THE IMPACT OF THE PROPOSAL.

	1961	1962	1963
		£ thousands	
KENYA			
1. Customs revenue	10,665	12,228	14,631
2. Current distribution	10,558	12,146	14,550
3. Exports	35,326	37,913	43,832
4. Revised distribution	7,039	8,579	9,936
5. Net change	-3,549	-3,567	-4,614
6. Net redistribution	-3,626	-3,649	-4,695
UGANDA			
1. Customs revenue	6,143	6,977	8,978
2. Current distribution	6,206	7,057	9,072
3. Exports	39,195	37,635	51,475
4. Revised distribution	7,800	8,521	11,664
5. Net change	+1,594	+1,464	+2,592
6. Net redistribution	+1,657	+1,544	+2,686
TANGANYIKA			
1. Customs revenue	7,718	9,486	12,391
2. Current distribution	7,733	9,488	12,379
3. Exports	48,667	51,241	63,553
4. Revised distribution	9,688	11,591	14,400
5. Net change	+1,955	+2,103	+2,021
6. Net redistribution	+1,970	+2,105	+2,009

Notes: The basic data on which this table is based are drawn from the Annual Trade Reports for 1961, 1962 and 1963 (published by the East African Common Services Organization). Customs revenue is shown net of a 3% deduction which currently goes to the revenues of the Common Services Organization. It is assumed that this charge is continued. The current distribution is estimated on the assumption that one half of the revenues charged to the distributable pool (6% of total customs revenue) is divided evenly between the three countries. The net change item is therefore an estimate of the change in revenues resulting from this proposal; the net redistribution also includes the small redistributive effects working under current arrangments. There is a minor innaccuracy in this table as no allowance has been made for charges against customs revenue of the costs of collection.

developed economy);

d) the businesses suffering the most are likely to be in strategic industries for future development;

e) one result of the transfer will be the expansion of markets in the less developed territory, expanding the possibility of inter-territorial trade

16. It seems likely that the **gross** income received by Kenya from inter-territorial trade lies somewhere between the value of its positive balance on the inter-territorial trade account and the absolute value of the negative balance on the external trade account. The net effect of the common market on Kenyan incomes is a much more hypothetical question, due to the points set out in the previous paragraph.

Appendix: a theoretical note.

A full examination of this proposal or any other plan for fiscal or monetary redistribution can only be properly evaluated with the aid of a fairly complete model of the operation of the East African economy. The case for a customs union in this type of economy rests largely on dynamic arguments - particularly relating to the benefits of economies of scale and of industrial expansion. Such an analysis is impossible here. Instead a very simple model is used (and is implicit in the discussion above).

If the simplifying assumption is made that there are no international capital movements between East Africa and the rest of the world then the argument is fairly straightforward. It can be developed most easily for two countries but applies to a three country union. Where we have

E_a & M_a as the exports and imports of country A to and from the rest of the world and E_b & M_b reppesenting the same for country B

then (1) $E_a + E_b = M_a + M_b$ (from the assumption of no international capital movements).

(2) $E_a - M_a = M_b - E_b$

Let us call the value represented by (2) V . The rate of customs duty will be represented by t where

(3) (Total customs revenue $= t(M_a + M_b)$
(Revenue (country A) $= tM_a$
(Revenue (country B) $= tM_b$

After the application of the proposal, revenue will be as follows

(4) Revenue(country A) $= \dfrac{E_a}{E_a + E_b} t(M_a + M_b) = tE_a$

The transfer is therefore equal to

(5) $t(E_a - M_a) = tV$

Now, it is the argument of this paper that V is likely to be very close to the sum of the net inter-territorial trade balance plus inter-territorial net capital flows. These net flows, it is claimed, are a good indicator of the bias of benefits flowing from the union. If there are substantial differences in the net benefits the partners received from international capital flows,the proposal as it stands would work to the fiscal disadvantage of the country which was attracting the greatest quantities of foreign capital. Against this, two points can be made. The leading country is likely to attract greater capital because it is the leading area within the common market and therefore attracts international capital to develop industries to satisfy more than its proportionate share of the combined market. Also, even if the capital flows have little connection with the structure of the common market, it seems likely that the long run viability of the market will be improved if the fiscal mechanism provides some check to divergent tendencies in a number of areas.

Finally, Professor Bell has urged that such a proposal ignores the possibility that imports, exports and inter-territorial payments may be rendered independent from each other through a mechanism of differential expansion of the territorial money supplies. This is a telling theoretical point, for it introduces the possibility of one territory growing faster than the others, with increasing exports, constant international imports and little change in inter-territorial payments. This territory could then receive a fiscal transfer from a partner with a lower growth rate and possibly lower income but which was importing relatively more and exporting relatively less although there were no inter-territorial payments transfers and no international capital movements /7/. While this seems true as a general point it does not seem to represent the East African situation. Possibly is will become much more important in the future.