

UDC 336.221.4.055:339.9.012.421(497.5)

FISCAL REFORM AND TRADE LIBERALIZATION PROCESS

Elida Liko

University of Tirana, Faculty of Economics
elida.liko@unitir.edu.al

Tonin Kola

University of Tirana, Faculty of Economics
tonin.kola@unitir.edu.al

Abstract

The main objective of this paper is analyzing the impact of trade liberalization on fiscal balance in Albania. A strategy that is broadly used in literature is combination of reduction in custom tariffs as a consequence of trade liberalization with an increase of consumption taxes, basically the increase of VAT and the increase in excise rate of imports. The main findings are that reduction of custom taxes is not being reflected in total fiscal income. This means that tax reform in Albania has been successful in having sound fiscal incomes during the trade liberalization process. An important contribution related to this performance has been played by VAT reform, and changes of excise duties.

Keywords: Fiscal reform, trade liberalization, transition

Introduction

The focus of this work will be the impact of trade liberalization on fiscal balance in Albania. The general trend of the EU trade policy toward developing countries has been increase of trade liberalization and simplification of trade regime; see Auboin and Laird (1998), Woolcock (2007). For the EU applicant countries, opening of economy toward foreign trade have brought about many domestic policy adjustments. Trade liberalization is generally accompanied by fiscal adjustment to maintain fiscal consolidation. This adjustment is important and needs to be studied as it is related to political decision, with implication not only with regards to short term macroeconomic stability but also for longer period of time.

The trade policy followed by Albania during transition process has been that of trade liberalization.¹ Albania has signed bilateral trade agreements with eight countries, Macedonia, Croatia, Bosnia and Herzegovina,

1) 16 September 1999 the council of minister resolution on export–import regime liberalized foreign trade and created facilitation

Serbia and Monte Negro, Rumania, Bulgaria, Kosovo, und Moldavia. All these agreements have become effective during the period 2002 - 2004. Besides these bilateral trade agreements, Albania has also signed other important agreements, such as that of March 2000 with European Council in Lisbon, saying that Stabilization and Association with west Balkan countries should be oriented towards asymmetric trade liberalization. The European Union signed in July a memorandum on liberalization and stabilization of trade with eight countries, including Albania. With regards to bilateral level, stabilization and association agreement with Albania started in February 2006. Albania has become a WTO member from 2000 and has liberalized customs regime in accordance with WTO disposal.

The goal of this study is to analyze fiscal reforms undertaken by governments, in different stages of trade liberalization. The investigation will try to find out whether these policies have been successful in maintenance of fiscal stability which on its part is necessary in definition of future course of fiscal policy.

Background

According to economic theory, the early effect of trade liberalization in trade balance will be the increase of trade volume, expecting increase both in volume of imports and exports. A strategy that is broadly used to combine reduction of custom tariffs, as a consequence of trade liberalization, is an increase of consumption taxation; basically increase of VAT and of excise rate for imported goods. Adjustment of both these taxes has been the center of fiscal reform in developing countries and has simplified them surpassing of substantial fiscal losses especially in short run in fiscal balance, see Emran and Stiglitz (2005), Bird and Rotman (2005), Aarnes (2004), Baunsgaard and Keen (2005), Tanzi and Zee (2000), Stosky and WoldeMariam (2004).

In their work, Tanzi and Zee (2000), besides the increase in consumption tax as part of fiscal reform, consider also the increase in income tax. Although use of this tax is limited, based on negative impact it has on investment and administration costs, this work will investigate for all possible strategies used by government to deal with fiscal losses caused by trade liberalization.

Imports are subject of VAT and excise taxes, and exports are generally excluded. Some authors such as Fitoussi (2005), argue that "[one possible hidden purpose for consumption tax could be the attempt to increase the competition. In reality, taxation of consumption between other things means taxation of imports and exclusion of export]". A similar conclusion was drawn by Cnossen (2005) on excises applied on imported goods, he argues that "[excise tax brings about a discrimination of imported goods because exports are excluded]. Other authors such as Avi-Yonah and Margalioth (2006) have found evidence that the use of VAT has been more efficient than import taxes, because it does not discriminate between domestic and imported goods.

This work trying to make a comparison among countries' VAT and excise structure will investigate for possible competitiveness incentives. Excise literature review puts VAT adjustment in the center of fiscal reform in developing countries and shows that this tax has been more efficient compared to import taxes. This study after making a complete analysis of fiscal package will focus more on the efficiency of fiscal adjustment in short run and will investigate if initial adjustment needs further adjustment in order to maintain fiscal stability.

Taxes of foreign trade and fiscal income

The following graph shows total fiscal income versus customs income from year 1997. In the beginning of year 1997 customs tax was accounting for about 45% of total fiscal income, in year 2000 it accounted for about 14% and, in year 2005 it was about 9.5%. The trend has been decreasing in time. Albania actually uses five levels of customs tariffs, as follows, 0%, 2%, 5%, 10% and 15%.

The period of time, when these agreements have been in power, is very important, because the higher effect in fiscal income is expected to be during the first year of customs reduction, where reduction is higher than the following years, where it is less. During 1999 - 2000 there has been exerted an intensive work by gov-

ernment to reduce fiscal evasion. During 2001 - 2005 the state administration returned normality and the possibility for fiscal evasion was significantly reduced.

As seen from the reported figures the total tax income has been increasing during whole period under survey. The total customs taxes and their share versus total tax revenue have been decreasing in time but without affecting total tax incomes. This means that tax reform in Albania has succeeded in ensuring sounds fiscal incomes during trade liberalization process.

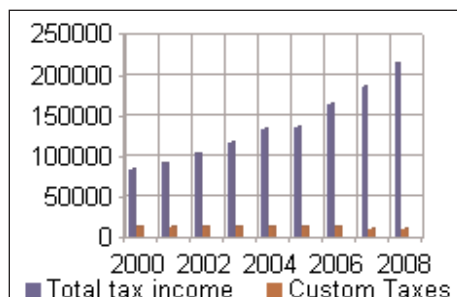


Table: Customs reduction according bilateral agreements

Year	2002	2003	1 January 2004	1 January 2005	1 January 2006	1 January 2007
Macedonia	22 March	90%	80%	70%	50%	0%
Croatia	27 September	80%	65%	50%	35%	20%
Bosnia and Herzegovina		23 April	60%	40%	20%	0%
Bulgaria		26 March	60%	40%	20%	0%
Serbia and Montenegro		13 November	60%	40%	20%	0%
Bulgaria		21 February	60%	40%	20%	0%

Source of data bilateral agreement

Albania Membership in WTO

Albania membership in WTO was approved on 17 July 2000. It became a member of WTO on 8 September 2000. Albania, in the framework of obligation from this membership, started since 2000 a process of reduction of customs tariffs, a process which went on with a continuous reduction year after year. The law number 8981 "On approval of customs tariffs" has been the basic law. This law has suffered amendments each year, reflecting changes in customs tariffs. These amendments are reflected in laws number 9159, 9330, 9462 for years 2003, 2004 and 2005 respectively.

EU and Albania

During 1992 was signed an agreement on trade cooperation between Albania and EU in the framework of Phare program. In year 1999 started the EU process of Association Stabilization with five South-East European countries, including Albania. The same year Albania gained trade preferences with EU. Year 2000 marked an increasing access of Albanian goods, without customs taxes with EU.

In the following table is calculated the RCA index which measures the comparative advantages of a country for specific commodity related to foreign trade partners.

$$RCA_i = \frac{(x_i^j - m_i^j)}{(x_i^j + m_i^j)}$$

RCA_i Measures the comparative advantage of a country in the production of a specific commodity i related to a given country j

x_i^j is the value of export of commodity i in the given county j

m_i^j is the value of imports of the commodity i in the given county j

Table: RCA index with main trade partners

Code	Commodity	Italy	Greece	Gernany	Turkey	Others
	Total	-	--	---	---	---
SITC 1	Food, beverages, tabocco	--	---	--	---	---
SITC 2	Minerals fuels, electric current	+	---	---	---	--
SITC 3	Chemicals, rubber products	---	---	---	---	---
SITC 4	Leather and leather manufacture	--	--	---	++	-
SITC 5	Wood and paper products	-	--	---	---	---
SITC 6	Textiles, clothing, footwear	+	+	+	---	---
SITC 7	Construction materials and metals	-	--	--	---	--
SITC 8	Machinery and transport equipment	---	---	---	---	---
	Others	--	--	---	---	---

RCA values between 0.7 and 1 (+++)

RCA values between 0.35 and 0.7 (++)

RCA values between 0 and 0.35 (+)

RCA values 0 (0)

RCA values between 0 and -0.35 (-)

RCA values between -0.35 and -0.7 (--)

RCA values between -0.7 and -1 (---)

The presence of Albania in EU markets is specialized in textiles and footwear. Of course there is a strong tendency to preserve and improve this situation in the future. Trade with neighbor countries, Albania has comparative advantage in group of products Leather and Leather manufactures. From the above reported data the foreign trade position of Albania is not very good. There is much to be done from our government in order to improve the foreign trade position of the country.

Customs incomes and VAT

One strategy for compensation of incomes reduced by customs tariffs is by increasing consumption tax, basically VAT. All imported goods in Albania are VAT subject. In developing countries reduction of customs tariffs with an increase in VAT taxation has been in center of the reform (M. Shahe Emran & Josef E. Stiglitz 2005). (Richard M. Bird & Joseph L. Rotman 2005) – If VAT could be administered in an adequate way, it offers the best way to substitute the losses due to trade liberalization). (Dag Aarnes 2004) – Reduction of imported tariff as part of trade liberalization is possible to cause losses in short term budget incomes. These losses could be eliminated through reduction of tariff exclusions in existing tax system, through excise rate for imported goods, or through consumption tax like VAT changes. (Vito Tanzi, Howell H. Zee 2000) – Reduction of customs tariff in developing countries, as a requirement of WTO membership, or bilateral agreement on free trade signed between countries could translate into important consequences in budget income in these countries. Reduction of tariff, if not accompanied with other trade barriers, generally brings about lower levels of effective protection. It also could bring important budget losses, at least in short term before the imported goods volume has sufficient time to be adapted. Other measures very often involve increase in consumption tax; rarely increase in income tax because of the negative impact in investment and administration. (Reuven Avi –Yonah, Yoram Margalioth 2006) – The tax reform in developing countries is substituting custom taxes with consumption taxes. The aim of this substitution is generally improvement of macroeconomic stability and introduction of the profits from foreign trade in developing countries. VAT is more effective than imported taxes, because this tax doesn't discriminate the goods produced in a given

country and imported goods. By eliminating import taxes, domestic consumer profits from lower prices in competition created between domestic and foreign producer, this strengthen the domestic producer to be more efficient and focus their efforts in comparative advantages).

In Albania VAT is constituted by Law No. 7928 of 27 April 1995. For imported goods is applied a standard rate of about 20%. For imported machineries and equipment from persons that are registered in tax offices is applied specific reimbursement of VAT. For this category of goods are not adapted customs duties.

Table: *Development of VAT in Albania*

1995	2001	2004	2005
VAT 0% for exported goods and international services	Are excluded machineries and equipment	Are excluded from VAT: Renting public building, university services, casinos	Is placed VAT for the first sale of residences, for airplanes flying, for leasing services. Are excluded subcontracts and some services related to merchandise

Source: Ministry of Finance

Excise tax

The Law on excise in Republic of Albania that corresponds with time under survey in our study are:

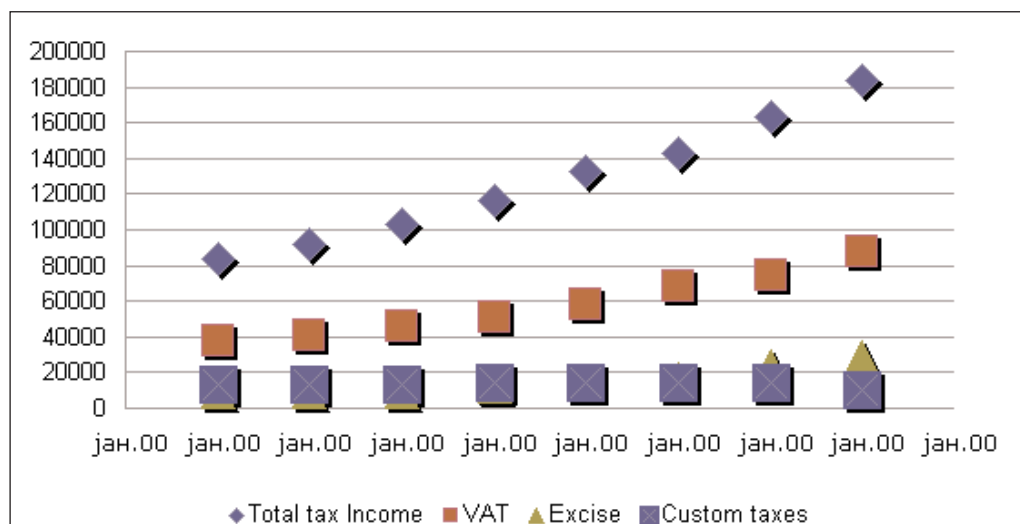
Law No. 8437 of 28 December 1998 "On excise in Republic of Albania," Law No. 8717 of 15 December 2000 "Related to alcoholic drinks and tobacco," Law No. 9136 of 18 December 2003 and Law No. 9328 of 6 December 2004 "On taxable commodities in Republic of Albania and excises"

Table: *Changes in excise duties*

	6 December 2004	4 August 2006	9 July 2007
First group: Coffee	40lek/kg -250lek/kg	Increase 10lek/kg-20lek/kg	50lek/kg-100lek/kg
Second group:			
Non alcoholic drinks	2 lek/liter	N/O	N/O
Third group:	20lek/liter-200lek/liter	Increase 20 lek for strong alcoholic drinks with alcohol more than 12%	N/O
Alcoholic drinks			
Fourth group: Tobacco	1500lek/kg-2240lek/kg	N/O	N/O
	25lek/for tobacco stick	Increase 15lek	40lek
Fifth group: Oil	13lek/liter-38lek/liter	N/O	37lek/liter-50lek/liter
	40lek/kg for residuals	N/O	N/O
Sixth group:			
Cosmetic commodity	60% of their value	N/O	N/O

Source: Ministry of Finance

Performance of both these taxes versus total tax income is graphically presented from 2000 until 2009.



Both VAT and excise taxes have marked a positive impact on total fiscal revenues. Both taxes have been increasing during all the period of trade liberalization process. Adjustment of excise in year 2006 has reflected a small positive impact in budget income generated by it. It is noticed a significant positive impact due to a broadening VAT base during 2005, in level of total income generated by this tax during next year. Therefore both taxes have positively contributed in generating fiscal incomes and avoiding the negative impact of customs taxes reduction during trade liberalization process.

Conclusion

Trade liberalization in Albania is followed as expected by an increased volume both in import and export. Regardless the fact, that during 2002 - 2005 it is noticed a faster increase in export versus import, the trade balance deficit in Albania has been high and increasing as tendency. Trade with neighboring countries, Albania has free bilateral trade agreements, is low as opposed to total trade volume of the country. Liberalization process has marked a positive impact in increasing total trade volume with these countries.

Total customs taxes share versus total budget revenue has been decreasing in time, without being reflected in total fiscal incomes generated by the government. This means that tax reform in Albania has succeeded in ensuring sound fiscal incomes during the trade liberalization process. An important contribution related to this performance was played by VAT reform and changes in level of excise.

References

- Emran, M. and J. Stiglitz (2005). On Selective Indirect Tax Reform in Developing Countries. *Journal of Public Economics* 89, 599-623
- Bird, R. and J. Rotman (2005). Value –Added Tax in Developing and Transitional Countries: Lessons and Questions. *First Global International Tax dialogue Conference on VAT Rome*
- Aarnes, D. (2004). Tax Policy for Developing Countries. *Background Paper for Seminar in NOARD*
- Tanzi, V. and H. Zee (2000). Tax Policy for Emerging Markets: Developing Countries. *IMF Working Paper, Fiscal Affairs Department, WP/00/35*
- Avi –Yonah, R. and Y. Margalioth (2006). Taxation in Developing Countries: Some Recent Support and Challenges to the Conventional View
- Baungsaard, T. and M. Keen (2005). Tax Revenue and (or) Trade Liberalization. *IMF Working Paper, Fiscal Affairs Department WP/05/112*
- Fitoussi, J. (2005) Shifting the Tax Burden: From Direct to Indirect Tax. *European Parliament, Committee for Research and Monetary affairs*
- Perroni, C. and J. Whalley (1993). Rents, regulation, and Indirect Tax Design. *NBER Working Paper Series No. 4358*
- Corsetti, G. (2006). Openness and the Case for Flexible Exchange Rate. *Centre for economic policy research, discussion paper series No 5612*
- Bacchetta, M. and Z. Drabek (2002). Effects of WTO Accession on Policy Making in Sovereign States. *World Trade Organization –Staff Working Paper*
- Norás, H. and R. Piernardini (2004). Infrastructure and trade. *World Trade Organization – Staff Working Paper*
- Auboin, M and S. Laird (1998). EU Imports Measures and the Development Countries. *World Trade Organization –Staff Working Paper*
- Drabek, Z. and J.C. Brada (1998). Exchange Rate Regime and the Stability of Trade Policy in Transition Economies. *World Trade Organization Staff Working Paper*
- Dobrowski, M. (2006). Current Account Imbalances and Monetary Union (Conceptual Issues).
- CASE –Center for Social and Economic Research**
- Broda, C. and J. Romalis (2003). Identifying the Relationship between Trade and Exchange Rate Volatility. *NBER Working Paper Series*
- Barkoulas, J., C. Baum and M. Caglayan (2000). Exchange Rate Effects on the Volume and Variability of Trade Flows.
- Moraga, J. and J-M. Viaene (2000). Trade Policy of Transition Economies. *Tinbergen Institute Discussion Paper*
- Richardson, M (1999). Trade and Competition Policies: Concordia Discors. *Oxford Economic Papers, Volume 51 Number 4, 649-664*
- Goldar, B and S. C. Aggarwal (2005). Trade Liberalization and Price –Cost Margin in Indian Industries. The Developing Economies, Volume XLIII Number 3, 346-373
- Goldar, B and A. Kumari (2003). Import Liberalization and Productivity Growth in Indian Manufacturing Industries in the 1990s. *The Developing Economies, Volume XLI Number 4, 436-460*
- Lachenmaier, S and L. Wössmann (2006). Does Innovation Cause Exports? Evidence from Exogenous Innovation Impulses and Obstacles using German Micro Data. *Oxford Economic Papers, Volume 58 Number 2, 317-350*
- Egger, P., M. Pfaffermayer and R. Schmidt (2007). Trade in Western and Eastern Europe in the aftermath of Comecon: an assessment of behavioral change. *Oxford Economic Papers, Volume 59 Number 1, 102-126*

- Campa, J.M, L. S. Goldberg and J. M. Minguez (2005). Exchange Rate Pass –Through to Import Prices in the Euro –Area. **Oxford University Press, Discussion Paper Series No 5347, Centre for Economic Policy Research**
- Edited by Cnossen, S. (2005). Theory and practice of Excise Taxation: Smoking, Drining, Gamling, Polluting and Driving. **Oxford University Press**
- Ahmad, E. and N. Stern (2001).The Theory and Practice of Tax Reform in Developing Countries. **Oxford University Press**
- Morley, B and N. Perdakis (2000). Trade liberalization, government Expenditure and Economic Growth in Egypt. **The Journal of Development Studies, Volume 36, No4**
- Calvo, G. A and A. Drazen (1997). Uncertain Duration of Reform: Dynamic implications. **NBER Working Paper Series No 5925**
- Liew, K-S., K-P Lim and H. Hussain (2003). Exchange Rate and Trade Balance Relationship: The experience of Asian Countries. **Faculty of Economic and Management of Malaysia Working Paper**
- J.E Lopez –Cordova & Chris Meissner (2001). Exchange Rate Regimes and International Trade: Evidence from the Classical Gold Standard Era. **Institute of Business and Economic Research, Centre for International and Development Economic Research (University of California, Berkeley)**
- Mihailov, A. (2003). Effects of Exchange –Rate Regime on Trade under Monetary Uncertainty: The Role of Price Setting. **Economic Discussion Papers No 566**
- Fernández –Albertos, J (2006). Trade Integration and the Politics of Exchange Rate Regime Choice. **Harvard University Working Paper (IPES Conference)**
- Broda, C and J. Romalis (November 2003). Identifying the Relationship between Trade and Exchange Rate Volatility. **Working Paper Chicago University**
- Dornbusch, R (1974). Tariffs and Nontrade Goods. **Journal of International Economics, Volume 4, 177 -185**
- Buffe, E.F (1995). Trade Liberalization credibility and Self –Fulfilling Failures. **Journal of International Economics, Volume 3, 51 -73**
- Tower, E. (1973). Commercial Policy under Fixed and Flexible Exchange Rate. **The Quarterly Journal of Economics, volume 87, No3, 436 -454**
- Woolcock, S. (2007). European Union Policy towards Free Trade Agreements. **ECIPE Working Paper No 03**