INTER-AMERICAN DEVELOPMENT BANK
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# Deepening Integration of MERCOSUR: Dealing with Disparities

## Asymmetries and Disparities in the Economic Integration of a South-South Customs Union

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The opinions expressed herein are those of the authors and do not necessarily reflect the official position of the IDB or its member countries.

**ASYMMETRIES AND DISPARITIES IN THE ECONOMIC INTEGRATION OF A SOUTH-SOUTH CUSTOMS UNION [1] [2]**

Marcel Vaillant[3]

## I. INTRODUCTION

MERCOSUR is a trade agreement still in transition. Its goal is to create a Customs Union in which goods, independently where they are produced, can circulate free from import tariffs within the integrated zone without requiring a certificate of origin.[4] This assertion can be inferred from what the trade agreement's decision making bodies have agreed in the past. In such an ideal situation, is necessary to have an allocation rule to distribute the collection of the Common External Tariff (CET) among the Customs Union members.

It is already well know how a Customs Union functions, both theoretical and in practice. This is less obvious in the case of MERCOSUR today. What it is clear is that MERCOSUR does not function as a Customs Union. The task at hand is to determine the desired direction for the agreement. The key question being posed today is what steps should be taken. It is necessary to find a suitable technical response to this problem, which could be implemented under the current conditions of the integration process.

The challenge is to make the integration agreement more consistent, determining an objective path towards the construction of a Customs Union that provides for free circulation within the zone. The current transition process is a complex one, and requires complex solutions that ensure that the steps to be taken are in the right direction. For any country or bloc of countries negotiating an agreement with another trade bloc, it is a prerequisite that this process be clearly established. If there is no Common Trade Policy (CTP) or clear trajectory towards building such a policy, joint negotiations with third parties will be severely restricted.

This article has two objectives. The first one is to analyze the possible changes that should be carried out in MERCOSUR in order to enhance its functionality. These changes should involve circulation of goods as well as customs revenues and the way they are allocated. The second objective is to evaluate the impact that changes in these the rules would have on disparities among the countries, considering the economic asymmetries now present.

We have structured this article into four sections, including this introduction. The following section analyzes the common trade policy and the rules of circulation in force (*status quo*), the stages that should be implemented to modify those rules in the future (a gradual

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[1] The analysis and opinions expressed in this work are the exclusive responsibility of the author and do not necessarily reflect the positions of the MERCOSUR Member States or of the MERCOSUR Secretariat.

[2] We are thankful to the participants of the "Deeper Integration of MERCOSUR: Dealing with Disparities" Workshop, February 2005 at the IDB in Washington for their comments and suggestions, in particular to Luis Villela who has provided comments on a preliminary version of this article.

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[4] In fact, in a complete Customs Union, the requirement of a certificate of origin for trade within the Union is considered to be equivalent to the existence of a non-tariff barrier. For example, in the European Union (See Mattera, 1991) a mandatory request for a certificate of origin is prohibited for intra-union trade. As it was pointed out by Mattera, "Certificates of origin (importation documents that provide proof of the origin of the product) must be included in the formalities prohibited by Article 30 of the EEC Treaty and those for which no exception is provided under Article 36 of EEC Treaty, whether they are demanded for products originating in the European Community or for products originating in third countries and placed in free circulation."

implementation of free circulation), and asymmetries associated with the rules of circulation. The third section addresses common customs revenues, how they are defined, what alternatives exist for their allocation, the path being taken by the MERCOSUR, the identification of relevant asymmetries to be considered in this case, and a proposed distribution rule. The final section sets forth the main conclusions of this work.

## II. TRADE POLICY AND RULES OF CIRCULATION IN THE CUSTOM UNION

### A. Common Trade Policy

The Common External Tariff (CET) has an 11 steps structure, with tariff levels from 0% to 20%, rising by 2% levels. The general rule for their design was the more added value the higher the level of the duty. Since the CET creation, MERCOSUR set up a period of transition toward a Custom Union, planning a convergence to the CET. Convergence was made by including national exception lists and sector lists. National list are defined by each country and MERCOSUR referee their length. Actually, national exceptions lists are regulated by CMC Decision Nº 31/03, that establish a maximum of 100 items excepted from CET to Argentina and Brazil, 649 to Paraguay (100 basics, 150 extra and 399 set up in the 4º article of CMC Decision Nº 07/94), and 225 to Uruguay (100 basics and 125 extra). The sector exception lists set up a period of convergence to Capital Good (BK in MERCOSUR acts) and Informatics and Telecommunication Goods (BIT). The level of CET initially accorded is 14% to BK and 16% to BIT goods. In these goods the countries are no committed to apply the CET. In table 1 the CET simple average is presented for non agricultural and agricultural products.

Table 1
**Common External Tariff and national tariff in 2004**
(Simple average in %)

| | ALL PRODUCTS | NON AGRICULTURAL PRODUCTS | AGRICULTURAL PRODUCTS |
|---|---|---|---|
| **MERCOSUR** | 10.0% | 10.8% | 10,1% |
| **Argentina** | 9.6% | 9.6% | 10,1% |
| **Brazil** | 10.9% | 11.0% | 10.3% |
| **Paraguay** | 8.9% | 8.7% | 10,1% |
| **Uruguay** | 9.1% | 8.9% | 10.2% |

**Source**: SM/SAT/CE, based on MERCOSUR norms and information from Party States.

The concept of a Common Trade Policy (CTP) is not merely restricted to the use or non-use of the CET. In addition to the definitions of the set of instruments that are included in the CTP, a further definition is needed with respect to the degree of application by the countries. Considering only the case of the application of the CET, two different criteria can be adopted:

i. A restrictive criterion, which would establish that the CET be applied in the same way by the four countries. If even one of the countries applied a different policy on a certain product (with upward or downward deviations from the CET) then, in this case, it would not be possible in practice to establish a CET, though it might be

possible to identify the arrangement as an agreed policy in the MERCOSUR agreements.

ii. An <u>inclusive criterion,</u> which would establish that the CET be applied by at least one of the member countries.

When the first criterion is used, unless the four countries apply the CET on a certain product, the circulation rule cannot be modified. When the second criterion is used, then even if only one country applies what has been agreed upon, the CET exists, though on a restricted basis, since it is not applied by all the countries.

The more restrictive criterion deems that a departure from the CET by any country could be an indicator that one or more countries have a preference for a greater or lesser protection from imports from outside the zone on that particular product. In this context, if a more universal circulation were to be established, it could generate conflicts, since the protective preferences would be dissimilar among the Member States. Nonetheless, in favor of the less restrictive criterion, it could be counter-argued that since a CET exists and has already been agreed upon, as expressed in a certain CET, then there ought to be incentives for compliance with the CET. In particular, if a country applies the CET, then products entering the zone under that policy should be favored with a more universal circulation, not only benefiting from an exemption from duties on originating products, but also on those to which the CET was applied or that were produced with inputs or raw materials from outside the zone internalized in a Member State that complied with the CET.

In the case of the more restrictive criterion, it could be argued that strictly speaking, the problem lies on upward departures from the CET, but not downward departures. For example, if one country has a higher tariff on a certain product and another country applies the CET, then if this good is allowed to circulate, it will not be possible to sustain the preference, on account of the higher tariff. On the other hand, the problem would not arise in the case of a downward departure. A synthesis of the two criteria would be to allow products to circulate that comply with the CET in the country importing them, provided that no other Member State is applying an upward departure.

Table 2 has a measure of the degree of application of CET in MERCOSUR. It contains the proportion of items where the CET applies in each country. The applying of the CET reaches three quarters of all CMN items (74.5%). The table shows also that Brazil is the country that most frequently applies the CET, in 95.3% of the cases. On the other side, Paraguay applies CET in 78.1% of the items (see panel (a) of table 2). The automobile sector had been negotiated separately and maintains a bilateral format, and sugar sector is nowadays out of negotiation. So, it makes sense do the analysis without those sectors. Panel (b) of table 2 shows that the applying of CET then rises to 76%. Panel (c) of table 2 shows that the applying of the CET without considering also the Capital Goods (CG) and Informatics and Telecommunications (ITG) goods rises to 87.5%. Finally, if it is also excluded the items included in the national exception list the remaining items without explaining their deviation from CET are very few: i) 43 in Argentina; ii) 3 in Brazil; iii) 180 in Paraguay and iv) 16 in Uruguay. In this case, the applying of the CET reaches more than 99% in each country except in Paraguay where is a bit less (97.5%).

Table 2
**Applying of CET in MERCOSUR countries**
(Number of items and percentage)

| | CMN | Applied | Non applied | % applied |
|---|---|---|---|---|
| **a. All products** | | | | |
| MERCOSUR | 9.750 | 7.259 | 2491 | 74,5 |
| Argentina | 9.750 | 8.625 | 1125 | 88,5 |
| Brazil | 9.750 | 9.292 | 458 | 95,3 |
| Paraguay | 9.750 | 7.616 | 2134 | 78,1 |
| Uruguay | 9.750 | 8.419 | 1331 | 86,3 |
| **b. All products without sugar and automobile sector** | | | | |
| MERCOSUR | 9323 | 7097 | 2226 | 76,1 |
| Argentina | 9323 | 8256 | 1067 | 88,6 |
| Brazil | 9323 | 8.918 | 405 | 95,7 |
| Paraguay | 9323 | 7.444 | 1879 | 79,8 |
| Uruguay | 9323 | 8046 | 1277 | 86,3 |
| **c. All products without sugar, automobile sector and BK- BIT** | | | | |
| MERCOSUR | 7.708 | 6.748 | 960 | 87,5 |
| Argentina | 7.708 | 7.566 | 142 | 98,2 |
| Brazil | 7.708 | 7.610 | 98 | 98,7 |
| Paraguay | 7.708 | 7.018 | 690 | 91,0 |
| Uruguay | 7.708 | 7.593 | 115 | 98,5 |
| **d. All products without sugar, automobile sector, BK- BIT and national lists items** | | | | |
| MERCOSUR | 6.953 | 6.732 | 221 | 96,8 |
| Argentina | 7.609 | 7.566 | 43 | 99,4 |
| Brazil | 7.611 | 7.608 | 3 | 99,96 |
| Paraguay | 7.182 | 7.002 | 180 | 97,5 |
| Uruguay | 7.608 | 7.592 | 16 | 99,8 |

(*) The National list excluded from the line of MERCOSUR is the union of four national lists. In each country the respective national list is excluded.

**Source**: SM/SAT/CE, based on information from the countries.

As it was mentioned before, the CTP must be defined with precision. In the current state of the integration process, the CTP includes both the CET and common tariff preferences with third-country markets.[5]. For example, a good may enter into the integrated zone from a trade partner of the rest of the world with which there is a common tariff preference. It is logical that such a trade partner, who negotiates jointly with a Customs Union, expects that goods entering one of the countries of the Union circulate freely within the Customs Union, without paying duties and without need for an additional certificate of origin.[6]

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[5] In the MERCOSUR, commitments have been established to negotiate in common with third countries. (See Decision 32/00 CMC).

[6] The above is not a hypothetical example. In fact, it is being discussed at the negotiating table with the European Union. It will be difficult to advance on an agreement with the EU if the MERCOSUR does not resolve this issue. Of course, if a solution is found for trade with the European Union, the lessons learned should by applied universally. In that way, the problem of redundant charging of the CET would be resolved based on a known path.

There are many other aspects of the CTP that have to be harmonized, but the process of building the Customs Union itself will be a dynamic one, enriching the concept of CTP. Many of these topics are under discussion in the MERCOSUR and some are nearly resolved. Without question, a trend towards common guidelines and behaviors favors a more universal circulation of goods within the integrated zone.

It is also necessary that administrative and operating procedures among the customs agencies of the various Member States be suitably standardized. The charging of import duties depends not only on tariff levels, but also on customs regulations from the ones that classify the product until those that establish the value (customs value rule) upon which the duties are applied. Also the Member States have yet to harmonize their special trade regimes with respect to third countries, and in fact, their defense mechanisms with respect to third countries differ (in particular anti-dumping measures). The countries also maintain certain non-harmonized preferential trade agreements. Furthermore, the members maintain the possibility of applying promotional policies to their exports in intraregional trade and apply defensive commercial policies in intraregional trade.

### B. Status Quo*: Redundant Collection of the CET*

According to the rules in force, goods produced within the MERCOSUR that comply with the rules of origin (native products) are the only goods that can circulate freely within the zone.[7] All the remaining, if they do not satisfy the rules of origin, cannot circulate freely without paying duties.[8] Therefore, if a good not produced in the zone (imported from outside of the zone) has already entered one of the member countries, but then crosses to another one within the MERCOSUR, the CET must be paid again. In this way, an association is established between the phenomenon of redundant collection of the CET and the certificate of origin requirement for free circulation of products in the zone. Because the rule of origin allows free circulation exclusively to native products, it thereby results a redundancy in the collection of imports tariffs on all goods that do not meet the origin requirements (that are not native goods).

This situation can be represented in a table of the various types of goods traded in a certain region, broken down by place of origin of the good and by whether or not a duty is paid in the importing country. We will restrict our analysis to a limited concept of free circulation, that is, whether or not duties are paid. Actually, free circulation is much more than the payment or non-payment of duties, depending on whether or not a customs authority is involved. If no customs authority involved, not only duties are not collected, but also another series of customs measures are precluded, which could have an equivalent effect to a duty.

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[7] The need to universally maintain rules of origin is fundamentally based on the very real possibility that the countries will not apply the CET. Decision 69/00 CMC [of the Common Market Council] authorized the member countries to continue applying the rules of origin to all tradable goods until December 31 of the year 2005. In addition, failure to put the MERCOSUR's Customs Code into practice (which is undergoing a revision process) creates difficulties from a technical point of view for applying a different criterion.

[8] Nonetheless, this circulation is restricted to the extent that, even if duties are not paid, internal customs becomes involved in all events. In practical terms, such involvement constitutes an additional restriction and could result in permitting the use of non-tariff restrictions. These notes make an abstraction of this phenomenon and liken free circulation to the non-payment of duties in intra-zone trade.

Table 3 presents the various situations potentially faced in an exchange between two countries, A and B. The rows list the types of goods in country A, an exporting country, specifying the origin of the goods in terms of the level of production transformation carried out within the integrated zone. The categories are the following:

a) The transformation is greater than the minimum level established by the rule of origin (whether the rule of origin is general or specific to the product).

b) There is production transformation, but it is less than the minimum required;

c) There is no transformation in Country A, but they are goods originating in the region (though not from Country A).

d) There is no production transformation and the goods are coming from Country A, but are produced in the rest of the world.

Within each category, a second classification criterion is used, distinguishing between whether the inputs (or even the product itself) entered the zone under the Common Trade Policy (CTP) applied in this case by Exporting Country A.

Table 3

**Redundant Charging of the Common External Tariff (CET): Typology of Goods**

| Country A = Exporter / Country B = Importer | Pays CET in B | Doesn't Pay CET in B |
|---|---|---|
| a) Produced in A and meeting rules of origin in A | | |
| • Inputs imported with CTP in A | | (1) |
| • Inputs imported without CTP in A | | (2) |
| b) Produced in A, but not meeting rules of origin in A | | |
| • Inputs imported with CTP in A | (3) | |
| • Inputs imported without CTP in A | (4) | |
| c) Not produced in A, but originating in the region (not A) | | |
| • with CTP in the region | (5) | |
| • without CTP in the region | (6) | |
| d) Not produced in A and not originating in the region | | |
| • with CTP in A | (7) | |
| • without CTP in A | (8) | |

**Source**: The author

These eight categories of products determine the current *status quo* of the integration process as a function of whether or not the CET needs to be paid when a product enters Country B as an imported good, that is to say, as a function of whether or not there is free circulation within the zone. That determination is made in the second and third column of Table 3.

Goods in categories (1) and (2) do not pay the CET. Since they meet the rules of origin, they can circulate freely within the zone according to the free trade agreement among the member countries. It should be noted that, for the goods of Type (2) in this table, a duty on the inputs has been paid that is different than the CET which applies to final goods (reasonably less).

Nonetheless, the goods of Type (2) circulate freely within the zone. This amounts to an accepted exemption to the CET.

Given that in the region, the certificate of origin requirement is indispensable due to the current transition in the integration process, the other three categories of goods ((b) Produced without meeting rules of origin; (c) Originating in another country of the region; (d) Imported by way of Country A from the rest of the world) must pay the CET when entering Country B. In these three cases, the CET must be paid even if the inputs for the product or the product itself entered country A under the application of the Common Trade Policy (which, in particular, might be the charging of the CET). Such a situation is the case of goods in categories (3), (5) and (7) shown in Table 3, which demonstrate redundant charging of the CET.

The concept being addressed is that of redundant charging of the CET. In local discussions, this phenomenon has received the name of "double charging" of the CET. In general, a good enters the zone according to the Common Trade Policy (CTP) in effect, is incorporated into a production process in Country A or does not undergo any transformation, and then circulates to Country B, where the CET has to be paid. In that case, there is a redundant charging of the CET in Country B, since it shouldn't have been charged, whether or not it was actually paid in full or at all in Country A.

Resolving redundancies in the charging of the CET calls for finding a solution so that three types of goods (Types 3, 5, and 7 in Table 3) will also be able to freely circulate in the zone.

Approximating the magnitude of the phenomenon through statistical measurements of redundant charging of the CET clearly underestimates the relevance of the issue (See SAT-SM-CE, 2004). To the extent that redundant charging of the CET is possible, economic players will naturally seek to avoid such a situation. Once the rules are modified, it is probable that the change will affect the trade flow and that a greater proportion of trade will be seen in goods of Types (3), (5) and (7). (see Table 1). Logically, while it is still possible that some goods will fall into categories (4), (6) and (8), it is understood that the integrated zone needs to have a mechanism to certify the origin and/or a mechanism that establishes when the CTP was applied to a certain good or the inputs with which it was produced.

### C. How the Issue of Circulation was Resolved in Europe?: The Free Circulation Rule

The concept applied to resolve the problem of circulation was called the general free circulation rule, found in the Treaty of Rome of the EEC.[9] Goods in free circulation are those coming from third countries, if the import formalities have been complied with and any customs duties or charges having an equivalent effect that are payable have been levied in a Member State, and if said goods have not benefited from a total or partial drawback of such duties or charges. It is understood that the goods enjoying a status of free circulation will enjoy equal treatment with goods originating in the intraregional zone.
The free circulation rule is defined in Articles 9 and 10 of the Treaty of Rome of the EEC.[10]

As indicated by Magariños (2000), free circulation rules of the EEC Treaty do not distinguish goods by their origin. Rather, all goods, whether produced in the Common Market territory or imported from outside that territory, can freely circulate in the integrated customs area. If the goods are imported, the following conditions apply:

i. import formalities have been complied with;

ii. any payable customs duties or charges having an equivalent effect have been levied in a Member State;

iii. the goods have not benefited from a total or partial drawback of such duties or charges.

According to Torrens, free circulation is a status or legal condition acquired by goods when they meet the characteristics mentioned above. A distinction should be made between this notion and that of being free from undergoing customs procedures (for non-tariff controls, from phytosanitary to tax controls). In Europe, customs controls on the goods traded within the zone (whether produced in the various Member States or imported and in free circulation) were maintained until 1993.

According to Mattera (1990) products introduced in the territory of a Member State that meet the following characteristics should be considered in free circulation:

i. They have paid duties and payable charges of an equivalent effect;

ii. They have not benefited from a total or partial drawback of such customs duties or charges (for example, by the exporter State);

[9] "*Libre pratique*" in French "*libre práctica*" or "*libre circulación*" in Spanish. Also termed "Free Movement" in English.
[10] Pursuant to Article 10, Paragraph 1, of the EEC Treaty: "*Products coming from a third country shall be considered to be in free circulation in a Member State if the import formalities have been complied with and any customs duties or charges having equivalent effect which are payable have been levied in that Member State, and if they have not benefited from a total or partial drawback of such duties or charges*."

iii. They comply with the import formalities established by the importing Member State (in particular, the European Community or national formalities compatible with the Treaty to which the importation of the products in question is subject).

The "Donckerwolcke" decision from the European Court of Justice confirms the idea that goods in free circulation receive the same treatment as originating goods.[11]

According to Torrens (unpublished source), a distinction should be made between the condition of "being in free circulation" and measures applied to goods subject to national exemption rules instead of a CET. The EEC Treaty addresses this through the application of a "procedure/mechanism" to prevent Country A, with more permissive importation rules, from being used to place goods in Country B, where a more restrictive rule applies (former Article 115 of the Treaty Establishing the European Economic Community, current Article 134 of the EEC Treaty)[12].

In this regard, Mattera (1990) indicates that the rules of Articles 9 and 10 do not, however, undermine the right granted to the Member States to invoke Article 115 of the EEC Treaty and request authorization from the Commission to exclude the products in question, in whole or in part, from the benefit of free circulation of goods, when the requirements established by said Article are present.

As determined by the European Court of Justice in the Tezi Decisions, in order to apply free circulation to products, a Common Trade Policy (CTP) must be applied. Therefore, the task is to precisely define what a CTP is. This topic has led to a broad and rich discussion in Europe that will not be developed in this section.

The Court's Tezi I Decision indicates:[13] *"...The court recognized that the incompleteness of the Common Trade Policy, together with other circumstances, was likely to maintain differences in trade policy between the member states capable of causing deflections of trade or economic difficulties in some member states.*

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[11] See ECJ, Decision of December 15, 1976, Donckerwolcke, Case 41/76, Rec. 1976, p. 1921 (§§16-18): "*Products in free circulation are to be understood as meaning those products which, coming from third countries, were duly imported into any one of the member states in accordance with the requirements laid down by Article 10*

*It appears from Article 9 that, as regards free circulation of goods within the [European] community, products entitled to 'free circulation' are definitively and wholly assimilated to products originating in member states.*

*The result of this assimilation is that the provisions of Article 30 concerning the elimination of quantitative restrictions and all measures having equivalent effect are applicable without distinction to products originating in the community and to those which were put into free circulation in any one of the member states, irrespective of the actual origin of these products."*
[Unofficial English version per http://www.curia.eu.int/en/content/juris/]

[12] Article 115 of the EEC Treaty states that: "*In order to ensure that the execution of measures of trade policy taken in accordance with this Treaty by any Member State is not obstructed by deflection of trade, or where differences between such measures lead to economic difficulties in one or more of the Member States, the Commission shall recommend the methods for the requisite co-operation between Member States. Failing this, the Commission shall authorize Member States to take the necessary protective measures, the conditions and details of which it shall determine.*

*In cases of urgency, Member States shall request authorization to take the necessary measures from the Commission, which shall take a decision as soon as possible; the Member States concerned shall then notify the measure to the other Member States. The Commission may at any time decide that the Member States concerned shall amend or abolish the measures in question.*

*In the selection of such measures, priority shall be given to those which cause the least disturbance to the functioning of the common market."*

[13] See ECJ, Decision of March 5, 1984, Tezi I, Case 59/84, (Rec. 1986), p. 887 (§§32-33). [English based on unofficial version per http://www.curia.eu.int/en/content/juris/]

*The court stated that Article 115 enabled difficulties of this kind to be overcome by giving to the Commission the power to authorize Member States to take protective measures, particularly in the form of derogations from the principle that goods originating in non-member countries and released into free circulation in one of the member states, should circulate freely in the community."*

Differences in trade policy and a resulting deflection of trade can be invoked by the Member States in order to apply Article 115. Furthermore, those differences can create economic difficulties, which can also be invoked in order to apply that article.

It is relevant to mention the most frequent differences in trade policies in the antique EEC. Three types of differences were identified: i) national restrictions compatible with European Community Law (measures in effect prior to the entry in effect of the Treaty, for example, quantitative restrictions on imports of Japanese automobiles in Italy); ii) quotas under the Multifibre Agreement; iii) regional protective measures (quartz watches in France).

It is understood that such differences can result in deflections of trade, jeopardizing the application of the trade policy measures mentioned above. Accordingly, free circulation becomes a means to elude the trade policy measures adopted by a Member State, given that, if the Commission does not intervene under Article 115, a direct flow can be avoided in favor of diverting trade through another Member State that does not apply restrictive measures on the third country in question.

According to Pelkmans (1997), the application of national quotas to various industrial products (textiles and clothing, autos, footwear), reintroduced in the nineteen seventies and the early nineteen eighties, made the European Community appear more like a free-trade zone than a Customs Union with respect to the intraregional circulation of that set of products. The result was a difference in prices in these sectors, despite of the existence of intraregional trade. This situation can be understood, given the rights of Member States to request application by the Commission of Article 115 when national quotas were still in effect. For 80% of the requests in the clothing and textiles sectors, the Commission granted such authorization (Pelkmans, 1994, cited in Pelkmans, 1997).

A concluding remark that rises from the EEC experience is that free circulation was a fundamental instrument applied in the old EEC during the transition to a Customs Union. In the course of that transition, given that the CTP was still being developed, it was necessary to provide correction mechanisms for possible deflections of trade. In the case of the EEC, this mechanism was set forth in Article 115 of the Treaty of Rome. Though, in some sectors, Article 115 of the Treaty of Rome was broadly applied, there are still problems in making an analogy to the MERCOSUR situation. The fundamental difference in comparing the first decades of the EEC to MERCOSUR probably lies in the fact that, in the case of EEC countries, the degree of similarity between national commercial policies and the CTP was greater. In the MERCOSUR, given the various sources of divergence, it is probably that the goods where the CTP applies cover a low proportion of the commercial universe with third parties. In this sense, though it is possible to apply the general rule of free circulation, it is necessary to know on which products it can be applied and on which it cannot. In the EEC, the opposite was true, free circulation was applied to all goods; then a exception mechanism

was designed making possible to exclude from free circulation those products for which it was presumed that a deflection of trade could occur, with this deflection being caused by disparities in the commercial policies among Member States (Article 115).

### D. New Rules of Circulation

The Problem

As indicated above, in the MERCOSUR today, circulation free from the payment of duties is restricted to those goods meeting the origin requirements subject to the direct issuance of certificates of origin between the exporting and the importing countries. Changing this rule of circulation is not easy, since a change might affect the distribution of customs revenues and the structure of protection in the bloc. With respect to the rules of circulation, two alternatives have been developed: one for the short term and another for the long term.

The short-term phase would consist in enacting, at the present stage of the development of the integration process, three general concepts:

i. In the first place, it would be necessary to allow goods originating in the MERCOSUR to circulate within the zone not only based upon the direct bilateral issuance of the certificate of origin but also that the certificate of origin would be granted general validity in the whole intraregional trade.[14]

ii. It must be possible to determine which products entering any of the MERCOSUR Member Countries comply with the CTP and which do not.[15] Products that comply with the CTP should be certified by the customs agency of the Member State through which they have been introduced.

iii. Goods that comply with the CTP should be assimilated to native goods, that is to say, they should be able to circulate duty-free within the zone. They should also be considered as if they were originating goods in any production process that transforms them within the region. That is to say, they would be in conditions of free circulation.

This procedure resolves the problem of duty-free circulation for native goods and for goods that comply with the CTP, thereby eliminating the redundant charging of the CET. In

[14] Some goods originate in the region but not in the country of the exporter. Given that certificates of origin up to now have been valid when directly issued by the exporting country to the importing country, in the case of regional trade, as is seen in Table 1, category c), goods originating in the region but not in the country of the exporter would pay the CET in the importing Country B (See Table 1, Types (5) and (6)). Nonetheless, as stated at the end of Article 10 of Decision 1/04 [of the Common Market Council], following letter d): "The certificate of origin issued by one of the Member States of the MERCOSUR allows for the circulation of the goods among the Member States with the same preferential tariff treatment and the same certificate of origin, provided that the goods are coming from any MERCOSUR Member State." If in the near future this part of said Article is regulated and customs procedures are adopted to implement it, then in the future this category of goods would not pay the CET in intraregional trade. The restriction on the circulation of originating goods is consistent with the application of certain fiscal exemption instruments in intraregional exports. If the exempted goods can return to the country that exported them, then this would be equivalent to extending the validity of the benefit to the domestic market. A typical example is the application of temporary admission in intraregional trade. On the other hand, if the originating goods could circulate freely, the instruments of commercial defense applied in intraregional trade (anti-dumping) would no longer be logical, since it would not be possible to sustain price discrimination.

[15] A product is understood to be a good classified up to the level of 8 digits of the Mercosur Common Nomenclature.

addition, this general rule could also contribute to building an overall solution to the problem of the accumulation of production processes, which has also been brought up in the MERCOSUR negotiations. Indeed, if an input or raw materials enter a Member State pursuant to the CTP, then, upon their integration into a production process, when they undergo any level of transformation, the processed good should be able to circulate duty-free within the MERCOSUR, and then undergo successive transformations in the region, allowing the product to be perfected up until its final consumption inside or outside the region.

It is necessary to analyze the problem in depth, not only to change the rules of circulation in the right direction, but also to ensure that such steps create the right incentives to allow the agreement to advance. That is to say, each step would lead to the next one, and in this way, the road would be paved for a complete Customs Union (the final objective). The mechanism to be designed is not simple of formulating, as it is intended to be general self reinforcing. That is to say, once the mechanism is applied, the private and public incentives must leading to its progressive application, so that the coverage of the CTP will intensify.

The alternative for the long term is to build a unified customs territory that crystallizes into a Customs Union. This requires several additional trade policy instruments, such as: Special Common Trade Regimens; Common Commercial Defense vis-à-vis third countries; Elimination of policies for the promotion of exports in intraregional commerce; Elimination of commercial defense policies in intraregional commerce; and a Uniform Customs Code. It would also be advantageous to have a Policy in Defense of Common Competition.

This scenario is the one defined in the foundational texts of the MERCOSUR, and for that reason, is called the final objective. The MERCOSUR is moving in this direction, but this process takes time and calls for a combined of political, institutional, and technical efforts that would be difficult to achieve in the short term. Such an option will not, therefore, be further developed in these notes, since this document focuses its effort on finding a solution that could, in fact, be adopted at the current level of development of the MERCOSUR integration process. If it is deemed that such an option is the best one, then steps should be taken in the direction of completing each of the preliminary instruments needed to constitute a common customs territory, as listed above.

The Solution Found

One would expect a Customs Union to be capable of attaining a more universal circulation in intraregional trade. In the same way as other complex problems, MERCOSUR took a gradual approach. In the year 1994, no sooner was the CET created than discussions began in its convergence process regarding how the rules of circulation should be modified. This matter was referred to as the problem of "double charging." [16] Its treatment was put off until the year 2000, when, in the context of re-launching the MERCOSUR, the Common Market Council (CMC) by express decision entrusted the MERCOSUR Trade Commission (MTC) with addressing the issue of double collection and distribution of the corresponding portion of the

[16] The discussion on double charging has a long history in the MERCOSUR, starting in the year 1995 with a request for consultation presented by Argentina and addressed to Brazil. See Request for Consultation No 70/95 in the realm the Trade Commission, "Double Charging of the CET" presented by Argentina and addressed to Brazil (Record 5/95, VI MTC).

customs revenues.[17] The countries engaged in a long dialogue in the context of the Trade Commission. Though the members' positions have evolved, they can be summed up into the following three approaches:

i. With nuances, both Argentina and Uruguay have expressed an interest in obtaining more universal conditions of circulation. They have been promoting a discussion, in view of reaching a solution that can be implemented on the basis of the current state of the integration process.

ii. Brazil has been evolving from a prudent, restrictive position with respect to the problem of "double collection," to recognize that it is necessary to find a solution to the problem. On the other hand, it has promoted the reasonable criterion throughout the period of transition that rules of origin are applied to the entire universe of goods.

iii. Paraguay has systematically pointed out the series of weaknesses characterizing MERCOSUR if it wants to function as a Customs Union, and has advocated that progress needs to be made on those issues. Paraguay insists that the weaknesses of the Customs Union should be treated globally prior to considering a solution today to the problem of double charging. Paraguay's concern was focused on the possible sacrifice in fiscal revenues that could result from implementing a solution to the problem of "double charging," treated in isolation, without likewise considering the issue of customs revenues collections.

This dialogue among the countries culminated with a request to the MERCOSUR Secretariat to draft a proposal during the first half of 2004, suggesting a mechanism to eliminate the double collection of the CET and also proposing a solution to the distribution of customs revenues.[18] During 2004 the MERCOSUR Secretariat prepared a series of works with the objective of making the discussion more specific and concrete (See SM-SAT-CE, 2004 a) b) c) and d)). At the level of the negotiations, during the Argentine Pro-Tempore Presidency in 2004, many alternatives versions of the new regulations started to be considered.

Recently, (Brazilian Pro-Tempore Presidency, Belo Horizonte Summit December 2004) the CMC approved a norm that will regulate the process of moving towards a Customs Union during the transition period from 2005 to 2008.[19] This is a key regulation, which clearly constitutes a milestone in the process of building the Customs Union. The regulation is complex and requires a detailed analysis. Its first four articles set forth the key aspects of the new regulations.

Article 1 clearly defines the concept of free circulation, which is an innovation for the MERCOSUR. Goods imported from third countries entering the zone under the CTP (CET, common preferential treatment, or common commercial defense), when circulating in intraregional commerce, will receive the same treatment as originating goods.

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[17] See Decision No. 27/00 of the CMC (Article 3), Buenos Aires 6/29/2000.
[18] See Work Schedule 2004-2006 CMC Decision No. 26/03, Chapter 1 "*MERCOSUR Económico Comercial*," Section 1.1 "AEC."
[19] See Decision 54/04, CMC.

Article 2 limits the field of application of free circulation to goods that enter the region with a 0% CET or with a common customs preference of 100%. This differentiation responds to the objective of implementing the regulation within no more than one year (See Article 3). Article 3 calls upon the MTC to prepare regulations for Articles 1 and 2 prior to December 31, 2005, along with a positive list of goods that comply with the criteria of Article 2.

These measures will have no impact on the distribution of customs revenues, since they affect a class of imported goods on which the revenues are zero. On the one hand, Article 2 provides a useful instrument for negotiations with third countries, given that the goods entering the zone with 100% preference may circulate on an intrazone basis in the same manner as originating goods. This overcomes one of the objections raised, for example, in the negotiations with the European Union.

Article 4 refers to the set of requirements that will have to be met in order to extend the rule of free circulation to the the goods not contemplated in Article 2. It sets a period of time for considering and resolving this issue (from mid 2005 until 2008). The requirements include: a) a MERCOSUR Customs Code (*Código Aduanero del MERCOSUR* - CAM); b) On-line interconnection of customs management computer systems; and c) distribution of customs revenues. The regulations include six additional articles covering procedure.[20]

In conclusion, the solution adopted partially addresses the concerns of all Member States. In the short term, it allows for certain specific changes in circulation. It is worth noting that goods entering with a 100% preference will be in free circulation, thereby strengthening joint negotiations potential with third country markets. A term is established, (2008) as well as certain requirements for a new integration schedule for the rest of the products not considered in Article 2. The year 2005 is very important, since that is when the regulations should be developed to implement the rule of free circulation for the goods defined in Article 2 and in general.

## III. CHANGE IN THE RULES OF CIRCULATION AND ASYMMETRIES IN MARKET SIZES

The first and quite obvious advantage that MERCOSUR countries obtain through the integration process is preferential access to a market whose size is greater than their own. A simple exercise that measures the differential importance of the region is to consider the rest of the region with respect to any given country. Table 4 presents the results of such an exercise in terms of trade, production, and population. What first strikes the observer is a great asymmetry in the significance of the region for the countries forming the commercial bloc. For Brazil, the population of rest of the region is only 0.3 times its own. For Uruguay, a sparsely populated country, the rest of the block has a population 64.6 times greater than its own. If viewed in terms of production, for Paraguay the region is almost 124 times greater

[20] Article 5 entrusts to the MTC the task of defining the schedules to be applied on the rest of the products not covered in Article 2. This task is to be completed within 180 days following compliance with the requirements set forth in Article 4. Article 6 refers to implementation schedules. Article 7 instructs the MTC to take the necessary actions in order to satisfy the requirements of Article 4. Article 8 refers to goods in transit and states that the final destination of goods in transit will be considered the first port of entry into MERCOSUR territory. Article 9 states that the MTC shall make the necessary changes in the Rules of Origin by December 31, 2005 in order to comply with this decision. (Decision 54/04, CMC).

that its own economy. In the specific case of Argentina, we find a country that is in an intermediate situation in relation to the region. Though the bloc grants it access to a market several times greater than its own (almost three times greater in terms of production and five times greater in terms of population) its economy is not as small as that of Paraguay or Uruguay, where the weight of the regional market is great indeed.

Table 4

**Size Comparison: Ratios Comparing the Rest of the Region to a Given Country** [(a)]

| | Imports | | | Production | Population |
|---|---|---|---|---|---|
| | Total | Intraregional | Extraregional | | |
| **Argentina** | 3.5 | 1.9 | 4.1 | 2.7 | 4.8 |
| **Brazil** | 0.4 | 1.0 | 0.3 | 0.4 | 0.3 |
| **Paraguay** | 35.7 | 11.0 | 67.6 | 123.9 | 41.7 |
| **Uruguay** | 27.6 | 10.6 | 41.8 | 45.7 | 64.6 |

(a) Data for the average of the period 2000-2003

**Source**: owned estimations based on various data sources.

The bloc has a more balanced relationship, however, when the unit of measurement employed is the amount of intraregional commerce. Using that measurement, for Brazil, intraregional imports by the rest of the block members are equal in size to Brazil's own imports from the bloc members. For Argentina, this ratio is slightly less than two-to-one. The smaller and medium countries are relatively more oriented to towards buying within the bloc than from the broader global economy.

An essential need for the three smallest economies of the bloc (Argentina, Paraguay and Uruguay) is to be able to sell their production in the rest of the world. The small economies are structurally specialized, producing large quantities of a few products and consuming small quantities of a large array of products. This specialization can be associated with a certain external vulnerability, since the country is affected by conditions of access in foreign markets for the goods where it is specialized. International markets for products that provide the core comparative conventional advantages of the smaller countries of the bloc are sensitive to international conditions, on account of which external insertion may be problematic.

External vulnerability could be reduced through increasing the size of the market within which conditions of free trade are available, thereby making it possible to expand the range of products and sectors in which to specialize. For the smaller economies, economic integration provides one more instrument through which overcomes the restrictions inherent to a limited internal market. Modern technology for the production of manufactured goods is such that economies of scale have a dominant role in determining competitive production conditions. The larger the scale (the more one produces), the lower the average costs of production. International trade makes it possible to take advantage of these improvements in efficiency. Comparative experience shows that regional integration plays a central role in this process.

The three smallest countries of the MERCOSUR have yet to benefit from the effect of becoming integrated into a larger market. In the first stage, integration has been associated with a loss of participation of industrial products. Some recent works document this phenomenon in particular for Paraguay and Uruguay (see Sanguinetti, Triastaru, and Volpe,

2003 and Labraga and Lalanne, 2004). For Argentina the evidence is not clear. From more than two decades Argentina is in a decreasing trend of its share in global regional manufacture product, but in the nineties for a brief period the trend was reversed. Recently the contraction process was reinforced.

Table 5 outlines trends in the geographic concentration of manufacturing among the countries of the bloc over a long period, and confirms the effect in question. It is necessary to observe this phenomenon on a sub-regional level within the countries. Particular attention should be paid to the two countries with the largest geographic area, in order to make more relevant comparisons for analyzing geographic agglomeration trends of industrial centers in the block and their relative evolution in relation to the integration process (Terra and Vaillant. 2000).

Table 5
**GDP of the Manufacturing Industry in the MERCOSUR**
(Billions of Dollars constant price of 1995 and %)

| | **1980-1982** | | **1990-1992** | | **2000-2002** | |
|---|---|---|---|---|---|---|
| | **Billions of US$** | **%** | **Billions of US$** | **%** | **Billions of US$** | **%** |
| Argentina | 36.350 | 22.9 | 36.507 | 22.3 | 39.440 | 20.5 |
| Brazil | 117.415 | 74.1 | 121.986 | 74.6 | 148.008 | 77.1 |
| Paraguay | .991 | 0.6 | 1.218 | 0.7 | 1.300 | 0.7 |
| Uruguay | 3.798 | 2.4 | 3.772 | 2.3 | 3.207 | 1.7 |
| **MERCOSUR** | **158.554** | **100.0** | **163.483** | **100.0** | **191.955** | **100.0** |

**Source**: Owned estimation based on information from the Economic Commission for Latin America and the Caribbean (ECLAC).

The performance of manufacturing activities has relevance from various points of view. We could mention three: Manufacturing is an economic sector greatly affected by economies of scale; manufacturing participation is an indicator of the capacity to incorporate technical progress into production; improved manufacturing performance allows for a more dynamic labor market, enables growth, and creates high-productivity jobs. The economic integration process has been characterized by two essential characteristics that explain this poor industrial performance in the case of the three smallest economies of the bloc:

i. The elimination of duties on imports in intraregional commerce took place with a pre-announced sequence of stages that, in general, occurred as scheduled. Nonetheless, the same efficiency did not apply to eliminating non-tariff barriers (NTB's), which continued affecting intraregional commerce. The existence of non-tariff barriers (See Berlinski et al, 2001, and Vaillant, 2001) provides an incentive to concentrate investment and production in the large market, as a direct result of the effect of NTB's on prices as well as the uncertainty NTB's create for future results. The harm created by a barrier is not merely the direct effect of limiting the flow of trade. In fact, present decisions on where to locate manufacturing are also influenced by the perceived probability that these barriers will also be created in the future.

ii. Despite having adopted the format of a Customs Union, at present, ten years after the Protocol of Ouro Preto, MERCOSUR continues to function as a Free Trade Zone from the point of view of the rules that regulate the circulation of goods within the

integrated zone. This means that the only goods for which the customs preference is applied in intraregional commerce are those considered originating goods under the Rules of Origin (RO) in effect, as applied. This situation has a major impact on the capacity to attract industrial processes to economies with a smaller market size, which therefore have a lesser degree of vertical integration in their industrial structure. It has been demonstrated that the Rules of Origin translate into a higher price on regional inputs, whose demand is bolstered by the requirement of origin. Economies of smaller size that would potentially benefit from shorter chains of production cannot do so in the context of the current situation. Indeed, if the goods are not originating goods, even if they comply with the CTP (CET and common preferences with third countries), the duty must be paid again once the goods cross another border in the region (redundant charging of the CET).

Indeed, both the existence of non-tariff barriers and the continued application of the Rules of Origin to the entire tariff universe have meant that the elimination of obstacles and restrictions in intraregional trade have only gone halfway in terms of the potential degree of integration. Such an assertion can be empirically confirmed.

In the nineties, MERCOSUR advanced in eliminating duties intraregional trade. Nonetheless, nowadays, duties are an incomplete measure of protection, providing little information on the degree of restrictions in market access. To have a measure of the degree of restrictions, two alternative routes can be taken: to broaden and deepen the measurement instruments capable of discriminating domestic production from that of the rest of the world or; to develop indirect methodologies that can infer degrees of difficulty in obtaining access to the market using available information on production and trade. In a recent work Zignago and Mayer (2004) took this second road and estimated the impact of borders on discriminating domestic production from that of the rest of the world. The work proposes a micro-founded gravity-type model based on a well-known model of international trade that explicitly introduces the effects of the border-associated costs to estimate border effects.

Table 6

**Estimated Border Effects in Trade Agreements:**
**Number of Times that a Country Trades with Itself**
**in relation to Trade with a Foreign Country (Trade Partner)**

| | All Countries | North-North | South-South | North-South | South-North |
|---|---|---|---|---|---|
| All | 273 | 130 | 327 | 77 | 821 |
| Regional Trade Agreements | 42 | | | | |
| European Union | | 47 | | | |
| Canada/USA | | 52 | | | |
| MERCOSUR | | | 120 | | |
| ASEAN* | | | 81 | | |
| Andean Community | | | 330 | | |
| NAFTA | | | | 20 | 90 |

*ASEAN- Association of Southeast Asian Nations

**Source**: Owned estimations based on results of Zignago and Mayer (2004).

Table 6 presents estimates of border effects for the nineteen nineties. For the international economy, an average country buys 273 more times from itself than from any other country, if the other variables used as a control (market size, distance, duties, etc.) are similar. If the countries have a preferential trade agreement, then the effect of the border reduces to a value of 42 times. The results are very clear: preferential trade agreements lead to a significant reduction in the magnitude of border effects for the regions considered in this empirical analysis. This is particularly true for the four economies of the bloc being analyzed, though, as can be seen in Table 4, the magnitude of the border effect continues to be significant within MERCOSUR (where the ratio of domestic to foreign trade is 120 to one).

Zignago and Mayer (2004) also conducted an analysis over a long period of time, studying the evolution of border effects on the international economy and on regional blocs. The dynamics of border effects is characterized by a decreasing tendency, in particular inside a preferential trade agreement area. The two most successful experiences from the point of view of reducing border effects are the European Union and NAFTA. In the case of the regional approach among the four economies of the South, it is seen that the border effect reduced considerably during the ninety nineties, but is still high.

New Geography models that specify the complex interaction among economies of scale, trade costs (which includes, among others, transportation costs) and market size, demonstrate that the degree of industrialization of peripheral economies (that do not lie within the industrial core) have a non-monotonous U-shaped relationship with the level of depth attained by the integration process (Krugman and Venables, 1990). Venables (2005) analyzing the link between market access and industrial location says that: "*if two regions or countries are identical except that one is k>1 larger than the other, then (given the transport cost between the regions) industrial production in the larger region will exceed that in the smaller by a factor greater than k Furthermore, this fraction will vary with the level of trade cost*".

If the levels of integration are very low, industry is dispersed over space. As integration deepens, there are strong incentives to concentrate the production in places where the size of the market is greater. If the degree of integration intensifies effectively, then economies that were originally peripheral move closer to the industrial core and therefore increase their capacity to retain manufacturing production in their territory.[21] In conclusion, if a de-industrialization occurred in the smaller, peripheral economies of the MERCOSUR due to the economic integration, it was not because there was too much integration, but because there was too little. Given that the regional integration process only advanced on a few initial steps, a negative incentive was created for the geographic concentration of industry in the smaller sized economies, just as expected in the theoretical literature (the U-shaped pattern). Economic integration does not have a monotonous effect on disparities in the geographic concentration of industry considering the original asymmetries in market sizes. As Venables (2005) point out: ".. *the fundamental logic of this effect is that, while integration can create regional disparities, further integration will reduce these disparities*".

[21] Terra and Vaillant (1997) calibrated the core-periphery model for the economic geography of Argentina, Brazil, Paraguay, and Uruguay. Using simulations with low and intermediate levels of integration, they obtained this type of result for the countries of lesser size in the block.

Changes in the rules of circulation to more universal conditions, tending towards relaxing the rules of origin for the preferential circulation of intraregional trade (see point (ii) in this section), contribute to reducing disparities in the geographic concentration of industry associated with asymmetries in market sizes. Asymmetries in the size of the domestic market are associated with the degree of vertical integration of each economy. The rule of origin acts in a manner equivalent to a subsidy on exports of regional inputs. In this sense, very strict rules of origin benefit the larger economies. Changing the rules of circulation implies moving in the direction of making the rules of origin less restrictive. As a consequence, disparities associated with asymmetries in the market size of a Member State narrow as the integration progresses towards a customs union.

# IV. COMMON CUSTOMS REVENUES FROM THE CET

## A. Definition and Estimate

Both under the short-term alternative of promoting circulation (gradually applying the rule of free circulation) and under the long-term approach of creating a unified customs territory, common customs revenues are generated, whose allocation should be decided upon by the Member States (See III.2).

If a unified customs territory is formed, the common customs revenues will consist of all fiscal revenues generated in accordance with the Common Trade Policy (CTP) of the Customs Union. Fundamentally, these revenues will result from an application of the Common External Tariff (CET) to imports originating in non-preferential third markets.

For the short-term transition alternative, customs revenues whose allocation could be decided upon must be defined with highly precision. In this case, common customs revenues would be the sum corresponding to the value of the collections under the CTP (basically the CET) on imports affected by the rule of free circulation. Accordingly, the customs revenues to be distributed would correspond to the share of the duty revenues where the CTP has been applied on imports that freely circulate within the region. Under the guidelines set by the free circulation regulations, the amount of these revenues will be zero up until the year 2008, since no fiscal revenues will be collected on the goods allowed to circulate freely (which must either have a 0% CET or a common customs preference of 100%). Due to the fact that the approach being taken is a gradual application of the rule of free circulation, it is not expected that in the short run, this application changes the distribution of customs revenues.

Table 7 presents the calculated magnitudes of duty revenues for the MERCOSUR countries from 2000 to 2003. These figures do not represent the revenues that come only from the CET source, since they were calculated by adding the customs revenues corresponding to the application of each Member State's trade policy, considered separately, at the current level of convergence. Nonetheless, given that a duty-free trade zone nearly exists, it can be affirmed that the approximated revenues are the fiscal revenues associated with the import duties of an eventual Customs Union. It is important to consider both their total amount and their distribution among the countries. As observed in Table 7, duty revenues measured in dollars

at the current exchange rate fell intensely during the period analyzed. This drop is partially explained by the fact that imports dropped during the same period.

Table 7
**Tariff Revenues of the MERCOSUR Countries 2000-2003**
(Billions of dollars)

| | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|
| Argentina | 1938 | 1548 | 372 | 555 |
| Brazil | 4609 | 3837 | 2689 | 2632 |
| Paraguay | 140 | 122 | 86 | 103 |
| Uruguay | 158 | 179 | 125 | 131 |
| MERCOSUR | 6844 | 5685 | 3273 | 3422 |

**Source**: Owned estimations based on SM-SAT-CE, 2004.

It was estimated that average customs revenues for the MERCOSUR countries taken together during the period of 2000-2003 added up to 4.806 billion dollars. The weighted average tariff for the period in question was 7.7%, considering only imports of extraregional origin. The ratio of the tariff revenue to the aggregate GDP of the MERCOSUR countries over a similar period was 0.6%. Finally, the average amount of customs revenues for the MERCOSUR, considered as a whole, was US$ 22 per person per year.

### B. Customs Revenues: What to do with them?

There are alternative approaches that deal with *the allocation of the common revenues issue*. Common Revenues can be transferred to each of the Member States based on the destination of the imports; they can be distributed in accordance with a general rule; or they can be used for financing a shared policy of the bloc. Those alternatives can be classified in four different options from a theoretical point of view:

i. *Status quo* – This approach would maintain the current situation, where the Member State collecting the CET is the one that appropriates the revenues.

ii. Exact Fiscal Offset – Using this approach, an exact fiscal offset would be made, with the final destination of the imported or extraregional goods determining which country would be credited with the CET.

iii. Rules of distribution of the revenues – Using this approach, the amount of customs revenues from the CET would be determined and distributed among the Member States based on a general rule considered acceptable.

iv. Fund for financing shared policies – Using this approach, the countries would collaborate, contributing the customs revenues to a common fund that would finance shared policies.

The alternative chosen depends upon the objective pursued by the integration process in question. One objective might be that the changes in rules of circulation (those that are associated with the functioning of the Customs Union) be neutral from a fiscal point of view, in the sense that they do not affect the public finances of the Member States. Other objective would be to have a distribution mechanism that instruments a type of transfer system, which would allow weakening some kind of disparities among countries (transfers would take the direction from the rich to the poor or from the large to the small countries). Finally, a third objective might be to create a fund with which to finance shared policies favoring the integration process.

The first option is to do nothing and maintain the *status quo*. The Member State whose customs agency collects the duties would be the one that appropriates the corresponding revenues. This alternative might inflict fiscal harm on certain Member States, specifically on those with fewer extraregional imports under the new free circulation rules than under the *status quo,* which does not provide for free circulation. A deflection of the duty revenues would occur in favor of some countries, to the detriment of others. Though the change in the rules of circulation would have favorable effects (See Section II.4) from the point of view of reducing economic disparities associated with asymmetries among the countries, the maintenance of the *status quo* scenario might increase economic disparities in ways not yet known.

The second option is to consider a criterion of revenue distribution based on the final destination of those imports covered by the rule of free circulation. In such a context, a customs procedure would have to be established at the micro level (on each operation) disclosing the content of the CET collections corresponding to goods in free circulation that are incorporated into the goods exported in intraregional commerce. After that, an offsetting mechanism among the Member States would need to be established for the transfers.

The third option involves using a distribution rule. This would require a calculation of the common customs revenues corresponding to CET collections, which would be turned over to a common institution. This institution could distribute the revenues collected considering an agreed-member rule, which would take into account characteristics of each Member States.

The majority of Customs Unions known have used the third alternative: general rules for customs revenues distributions. Simple rules of distribution include the following:

i. To distribute common revenues in accordance with each country's proportion of the total population of the zone.[22]

ii. To distribute common revenues in accordance with each country's proportion of consumption,[23] which can be approximated through the value of the respective country's GDP.

[22] Rule for the distribution of customs revenues used in the Germanic Zollverein.
[23] Rule for the distribution of customs revenues applied in the Commonwealth of Australia.

iii. To distribute common revenues in accordance with each country's proportion of total imports.

iv. To distribute common revenues in accordance with each country's proportion of extraregional imports.[24]

v. To distribute common revenues in accordance with each country's proportion of the intraregional imports.[25]

vi. To distribute common revenues in accordance with each country's proportion of extraregional imports entering the region under the CTP.

For quantification purposes, a period of reference needs to be defined, along with a methodology for updating the distribution rule. As mentioned above, certain simple rules have been traditionally applied, and complex rules can also be found. Some of the complex rules might contemplate other objectives for the distribution of common customs revenues. The next section will delve into an alternative with such an orientation.

The fourth option is to capitalize a Fund that would be administered by the community, used to finance shared policies of the Member States. In this case, the common customs revenues could be a possible source of revenues for the fund, but not necessarily the only one. Other contributions could be made by the Member States for said purpose. Using this approach, the distribution of customs revenues is neither explicit nor direct, since the objective is to have the Fund finance shared policies. For example, the fund could be used to finance the shared institutions of the integration process; to improve the integration's administrative mechanisms (cooperation and customs coordination); to develop regional public goods (infrastructure for the integration, connectivity and energy resources); or for structural convergence policies on the level of the MERCOSUR itself to support the development of the less favored regions and countries.

The option of creating a Common Fund to finance shared policies is clearly the one that characterizes the European model. Unquestionably, when comparing all the alternatives, this approach is the most ambitious form of pursuing integration. The Europeans, in building a common fund to finance integration expenses, moved from lesser to greater degree, both in terms of the magnitude of the resources involved and in terms of the mechanism for creating the fund in relation to the Member States (see SM-SAT-CE, 2004). In a first stage (1958-1970) based on the Treaty in Rome, the fund was created using a system of governmental contributions.[26] In 1970 the system of using the community's own resources was introduced, as called for in the original agreements.[27] European Community resources have been classified into traditional community resources (the customs revenues; agricultural taxes or fees) and other community resources. Within the second category an additional type of

[24] Rule for the distribution of customs revenues applied in the Franco-Italian Customs Union in the late nineteen forties.
[25] Rule for the distribution of customs revenues used by the South African Customs Union.
[26] See Treaty of Rome (1957) Article 200. Contributions from the countries to finance the community budget were set as follows: Belgium 7.9%; Germany 28%; France 28%; Italy 28%; Luxemburg 0.2%; The Netherlands 7.9%. The contributions for the European Social Fund were slightly different: Belgium 8.8%; Germany 32%; France 32%; Italy 20%; Luxemburg 0.2%; The Netherlands 7%. The decision regarding community contributions is dated April 21, 1970.
[27] See Treaty of Rome (1957) Article 201.

community resource was later defined, based on a uniform percentage of the tax base for the Value Added Tax. Subsequently, a fourth category of community resource was created, calculated in proportion to the GNP of each Member State. This resource was created in the late nineteen eighties and is gradually becoming the principal source of revenues of the EU, overtaking the VAT-based contribution.

The latter three options (the Offsetting mechanism, the Distribution rule, or the common Fund) are relatively demanding from the point of view of institutional requirements and the need to create new shared structures to manage common CET revenues and allocate them based on one of the above-mentioned criteria. It is perhaps possible to gradually increase the degree of institutional density and levels of commitment among the Member States starting with the second option and moving towards the fourth option.

The third and the fourth alternatives require that the countries transfer common customs revenues to a fund that will manage their allocation. Yet one must not forget that simplicity in the method selected and ease of implementation is an important attribute to consider when choosing a solution. One method may be better than another in a given aspect, but difficult to implement and therefore not recommendable. The creation of new institutions or an expansion of the role of current institutions could face challenges of other types that are not analyzed in this proposal.

### C. The Alternatives Adopted by MERCOSUR

It is interesting to contrast the alternative proposals with the particular approach that the MERCOSUR is adopting in this regard. In fact, the MERCOSUR's approach is not a pure and simple one that can be classified within any of the general alternatives defined above. Recent history shows that the strategy implicitly adopted was to separate discussions on how to create a fund for financing shared policies from discussions on what to do with customs revenues.

In February 2003, during the Paraguayan Pro-Temp Presidency, at the initiative of the Paraguayan government, the treatment of asymmetries in the region was discussed.[28] Negotiations took place with deeply intensity during the year 2004 within the framework of the activities of a High-Level Group (HLG) specially created to analyze and develop a proposal on this issue.[29] In December 2004, two years after the discussions on the treatment of regional asymmetries started, the CMC decided to establish the MERCOSUR Structural Convergence Fund, known as FOCEM.[30] In the last meeting of the CMC (Asunción, June, 2005) the source, use, administration, and management of the funds was determined[31]. The fund would be earmarked to finance the following four programs:

[28] See *Tratamiento de las Asimetrías en el MERCOSUR, Propuesta del Paraguay* [Treatment of Asymmetries in the MERCOSUR, Proposal from Paraguay] Meeting XXIV of the CMC in June 2003, Minutes 01/03, Attachment 5, Working Document 01/03.
[29] The HLG was created by Decision 19/04 of the CMC (under the Argentine Pro-Temp Presidency).
[30] See CMC Decision 45/04.
[31] See CMC Decision 18/05.

i Structural Convergence Program: The funds of this program are directed to support the building of highways and bridges, the development and improvement of waterways, the innovation and improvements on communication systems.

ii Development of Competition Program: it attempts to enhance the integration of chains of production, to improve processes and quality of production, to promote research and development of new products and production processes, to increase cooperation between private companies and public organizations).

iii Social Cohesion Program: it aims to improve the quality of human capital, to reduce poverty and unemployment, to improve health systems, training programs, and retraining of labor.

iv Strengthening of Institutional Structures and of the Integration Process Program: resources of this program are directed to finance the MERCOSUR's operations and strengthen its institutional structure.

The size of the fund was not yet clearly defined in the first stage. Though some preliminary figures have been considered; the fund would channel approximately 80 million dollars. The reference of 0.02% of the gross regional product has also been mentioned (which would amount to slightly more than 220 million dollars). Finally, the referred norm (18/05) establishes the objective size of the fund in U$S 100 and a gradual path to achieve it (50% the first year, 75% the second year and 100% in the third year).Table 8 presents the size (millions U$S) and percentages that are expected to be applied for collections and disbursements of the funds among members.

Table 8
**Sources and Use of the Funds of the FOCEM**
(millions of U$S and %)

| | Sources | Uses | Net Transfers | Structure of Net Transfers (%) |
|---|---|---|---|---|
| Argentina | 27 | 10 | -17 | 22 |
| Brazil | 70 | 10 | -60 | 78 |
| Paraguay | 1 | 48 | 47 | 61 |
| Uruguay | 2 | 32 | 30 | 39 |
| | 100 | 100 | 0 | |

**Source**: Owned estimations based on minutes of the HLG.

The distribution of collections is in accordance with the size of the countries (measured as the participation in the GDP for the average of years 1998-2000). With respect to the allocation use of the funds by country, the criterion employed is not as clear, though it does seem to be favoring the smaller economies. If this model were implemented, then Brazil would be contributing 78% of the net transfers, whose prime beneficiary would be Paraguay, receiving the 61% of the funds. The second largest net contributor would be Argentina, which would provide 22% of the net contributions. Finally, Uruguay would be the second largest beneficiary, receiving 39% of the net transfers.

Discussions on the creation of a common fund have taken place simultaneously, parallel to discussions on customs revenues and their allocation. But the common funds mature in short period of time comparing with the distributions rules

The idea of building a common fund arose in response to a demand regarding the treatment of asymmetries in the MERCOSUR. Accordingly, the issue of the fund is closely associated with the issue of asymmetries. The particular asymmetries that would be considered, address both the size and the wealth of the economies, and such aspects would be taken into account for both collections and disbursements among the Member States.

As indicated, asymmetries, as they are being considered in the MERCOSUR, are important when deciding where to channel net transfers. Yet the common or integrationist objective for the use of the fund is fundamentally expressed in terms of the programs whose projects would be qualified for financing. What is contemplated for the first five years of the fund is to use funds exclusively for convergence and institutional strengthening programs, the latter of which would have a double ceiling, meaning that only a certain proportion of the fund may be used, up to a certain absolute limit. As such, in its first stage, the fund will be earmarked fundamentally for the same program that will always represent the largest budget disbursement (70% following this first stage).

As for what to do with customs revenues, few advances have been made in the MERCOSUR beyond the above-indicated decision on free circulation (See Point 3.2), which states that one of the three requirements in order to apply an universal free-circulation rule is to have developed a customs-revenues distribution rule prior to the year 2008. Once again, generally speaking, the three alternatives mentioned above are open (fiscal offsetting, distribution, and a fund) considering that maintaining the *status quo* has already been eliminated as an alternative.

In this regard, the main concern is focused on the necessary fiscal neutrality that the changes in circulation must have, considering the asymmetries that characterize the countries and potential prejudicial effects to any of them. This issue is analyzed in the following section.

## D. Asymmetries to Consider: Fiscal, Geographic and Relative Development

Selecting one of the alternatives for allocating common revenues requires first to define the objective pursued. It is also necessary to take into account the differentiated effects of each alternative over several aspects: the structure of extraregional and intraregional imports; the fiscal impact on each country's public finances; the effects on each country's CET preferences, and thus, on the new equilibrium of the CET.

Asymmetries among countries have multiple dimensions that need to be considered. Accordingly, the allocation of customs revenues should bear in mind the differentiated effects (increasing or decreasing economic disparities) that such measures could have. These asymmetries can be grouped into five different categories:

i. Fiscal dependency on import tariff revenues;

ii. Geographic;

iii. Relative development;

iv. Market size;

v. Relative factor endowments.

As it was mentioned above, the extent to which import tariff revenues contribute to each country's overall public revenues is a key element. Furthermore, in the case of MERCOSUR, it makes sense to analyze this aspect simultaneously with geographic and relative development asymmetries.[32]

Finally, there is heterogeneity in terms of factor endowments and therefore in the distinct trade specialization of the various countries forming the Customs Union. Some countries are exporters of goods in which the Customs Union is a net importer and protects them by the CET. Such a country will have a preference for a higher import tariff of those kinds of goods. This type of asymmetry has been discussed in an exclusively theoretical manner in the literature (Syropoulus, 2003), without including empirical studies. Though it is necessary to consider such types of asymmetry, they are not the most immediate problems being discussed. Rather, the primary focus has been on the fiscal repercussion for public finances, as well as over geographic and levels of development asymmetries. For that reason, asymmetries in terms of factor abundance have not been included in this paper.

### Proportional Relationship to Fiscal Revenues

The relevance of foreign trade revenue, relative to total fiscal revenue, in each country is given by Table 9.[33]The trend of this proportion in the nineteen nineties was an overall decline in the participation of the tax revenues associated with foreign trade in almost all countries. However, Brazil shows a different picture, since at the beginning of the 1990´s the level was extremely low while at the end of the period in question it was just over 3%. The liberalization of trade in the nineteen nineties, both in its discriminatory and non-discriminatory form, led to a decrease in duties, and, simultaneously, to an increase in imports. In other words, the trends of tax revenues behave in opposite direction with respect to the trends in foreign trade. It should be noted that during this period, revenues from foreign trade fundamentally consisted of revenues from import duties.

Table 9
**Revenues from Foreign Trade as a Proportion of the Overall Current Revenues in the Nineteen Nineties** (as a %)[34]

[32] In the previous section, we discussed asymmetries in the size of the countries vis-à-vis changing the rules of circulation, hence this issue is not addressed again in this section.
[33] The figures in Table 9 were estimated in a recently work, which was conducted by the Institute for the Integration of Latin America and the Caribbean (INTAL), (see Barreix and Villela, 2003).
[34] Revenues from provinces, departments and states of the federation are not considered.

| | 1990 | 1995 | 2000 |
|---|---|---|---|
| Argentina | 12.9 | 4.3 | 4.1 |
| Brazil | 1.8 | 3.8 | 3.4 |
| Paraguay | 19.2 | 22.3 | 13.5 |
| Uruguay | 8.3 | 4.1 | 3.1 |

**Source**: See CE-SAT-SM, 2004, Economic Study 001/04 a).

Based on fiscal information from the countries in question, the figures were updated for a recent period (2000-2003). Revenues corresponding to imports were calculated as a proportion of current revenues and of tax revenues for the central government.[35] Table 10 presents trends in import duties and their proportional relationship to the current revenues and tax revenues of each country. In the case of Paraguay, it is seen that revenues from import duties are averaging approximately 17% of tax revenues, without a clear tendency to fall during the period. In the rest of the countries this figure is situated between 6% (Argentina and Uruguay) and 9% (Brazil). In Brazil, even though import duties are significant in relation to tax revenues, they are not significant in relation to current revenues. Furthermore, these figures only consider revenues from the central government, without bearing state/provincial/departmental governments in mind, which, once again, in the case of Brazil, are considerable.

Table 10

**Participation of Import Duties in Tax Revenues and Current Revenues** (as a %)

| | 2000 | 2001 | 2002 | 2003 | Average |
|---|---|---|---|---|---|
| **Argentina** | | | | | |
| Import Duties/Taxes | 4.9 | 4.2 | 3.3 | 3.8 | 4.0 |
| Import Duties/Current Revenues | 3.6 | 3.1 | 2.4 | 3.0 | 3.0 |
| **Brazil** | | | | | |
| Import Duties/Taxes | 10.7 | 9.8 | 7.3 | 7.0 | 9.1 |
| Import Duties/Current Revenues | 3.3 | 3.1 | 2.3 | 2.1 | 2.9 |
| **Paraguay** | | | | | |
| Import Duties/Taxes | 18.2 | 17.5 | 16.7 | 18.1 | 17.4 |
| Import Duties/Current Revenues | 11.5 | 10.0 | 9.6 | 11.2 | 10.3 |
| **Uruguay** | | | | | |
| Import Duties/Taxes | 5.2 | 6.1 | 7.0 | 5.5 | 6.1 |
| Import Duties/Current Revenues | 4.1 | 4.9 | 5.1 | 4.5 | 4.7 |

**Source**: See CE-SAT-SM, 2004, Economic Study 001/04 a).

[35] In this recent period (2000-2003) export fees took on an unusual importance in the case of Argentina, due to a collapse in the rule of convertibility and to the subsequent macro-devaluation in early 2002.

### Geographic Asymmetries

As noted above, the new rules of circulation could provoke a change in the trade flows, associated with changes on the structure of imports whose geographic origin is extraregional. It is likely that a reconfiguration occurs in the distribution channels for extraregional imported goods. Along these lines, it is useful to refer to the observations made by Magariños and Terra (1998) regarding the relationship between the structure of the trade flow and the rules of commerce in the zone: "*Recently, the view has been voiced that in the near future, for technical and operational reasons, shipping services to the Atlantic Coast of the Southern Cone will have to focus on no more than two ports, one in Brazil and another along the Río Plata, in response to modern-day demands of transportation and cargo handling. The possibility of going through customs processing at the selected ports in a single act for goods bound for the entire sub-region clearly encourages this tendency*."

Furthermore, there may be a shift of production activities whose level of transformation is less than the threshold that defines an originating good. Changes in the structure of imports on the part of a member country affect the allocation of CET revenues given the current structure. In practice, at present, there is a distribution rule for the CET that is linked to imports. The country that collects the duty is the one that appropriates those revenues.[36]

Geographic factors affecting ease of contact with the rest of the world will be a determinant element in this new structure of imports. Therefore, if the rules of circulation change but the rules for the distribution of customs revenues do not, some countries might be adversely affected (those geographically farthest from the rest of the world) and others potentially benefited (those geographically closest to the rest of the world). In the case of MERCOSUR, there are three countries with an Atlantic coast (Argentina, Brazil, and Uruguay), while Paraguay is landlocked, which potentially places Paraguay in a less advantageous position if the current rules on customs revenues allocations remain unchanged.

### Relative Levels of Development

A *proxy* variable that may reveal the relative development of countries is their per capita incomes. If one considers this indicator for the case of MERCOSUR, one can perceive that there exist significant asymmetries among member countries. In fact, the three alternative measures that where estimated, the GDP per capita in Current US$, GNP per capita in Current US$ and the GNP per capita based on Parities of Purchasing Power, account for such asymmetries.

In 2002, GDP per capita of the MERCOSUR was US$ 2,586 in current dollars. In that year the GDP per capita of Argentina was 104.27% of the average for the bloc; that of Brazil was 100%; and that of Uruguay was 140%, while the per capita GDP of Paraguay represented only 40% of the average for the MERCOSUR (SAT-SM, 2004).

[36] More precisely, this rule may not applies is some cases due to the fact that countries can deviate from the CET upwards or downwards. There is a mix trade policy regarding the tariff that one country set on imports that come from third parties. That way of applying the trade policy on these imports by each member country, generates duty revenues when those imports are traded inside the bloc.

Table 11 presents alternative per capita income measurements using both the Gross Domestic Product and the Gross National Product in current dollars[37] based on purchasing power parities.[38]

In the year 2003, the GDP per capita of the MERCOSUR was US$ 2853 in current dollars. Argentina and Uruguay were situated at levels of 118% and 116% respectively, while Brazil's level was 98% of the average and Paraguay's dropped to 36% (see Table 11). For the GNP per capita at Purchasing Power Parity (PPP), the order is somewhat different. Argentina continues to be first in line at 136%, while Uruguay is situated at the exact average for the region. Paraguay is the country with the lowest per capita income, at 59% of the average, while Brazil is situated only slightly below average, at 93%.

As the data shows, between the years 2002 and 2003 significant changes took place in terms of per capita income among the MERCOSUR countries, due to the huge swings in the exchange rate. As of 2003 all the MERCOSUR countries have a floating exchange system and their bilateral exchange rates in real terms have tended to stabilize. In all events, certain common structural traits remain unchanged: Paraguay is the poorest country in the region, while Brazil is in the middle or slightly below average. In the case of Argentina and Uruguay, the order changes, depending upon whether one considers the data for 2002 or for 2003. In 2003, it is seen that Argentina is the country with the highest per capita income under any of the measurements used, while Uruguay is either average or slightly higher than average, depending upon the method employed.

Table 11

**Per capita income of the MERCOSUR countries, Year 2003**

US$ and Purchasing Power Parities (PPP)

a) Levels

| | **GDP per capita (Current US$)** | **GDP per capita (US$ at PPP)** | **GNP per capita (US$ (iii))** | **GNP per capita (US$ at PPP)** |
|---|---|---|---|---|
| Argentina | 3381 | 11586 | 3651 | 10920 |
| Brazil | 2788 | 7767 | 2712 | 7480 |
| Paraguay | 1030 | 4724 | 1101 | 4740 |
| Uruguay | 3308 | 8280 | 3818 | 7980 |
| MERCOSUR (i) | 2627 | 8089 | 2820 | 7780 |
| MERCOSUR (ii) | 2853 | 8352 | 2849 | 8008 |

b) Deviations

| | **Deviation in GDP per capita (Current US$)** | | **Deviation in GNP per capita (US$ at PPP)** | |
|---|---|---|---|---|
| | Simple | Weighted | Simple | Weighted |
| Argentina | 129 | 118 | 140 | 136 |
| Brazil | 106 | 98 | 96 | 93 |
| Paraguay | 39 | 36 | 61 | 59 |
| Uruguay | 126 | 116 | 103 | 100 |

[37] *World Bank Atlas method*. The data is converted from national currency to current United States dollars using the average exchange over a three-year period, in order to attenuate the effects of temporary changes in the exchange rate.

[38] Purchasing Power Parity used by the World Bank.

| MERCOSUR | 100 | 100 | 100 | 100 |
|---|---|---|---|---|

(i) Simple average, (ii) Average weighted by population, (iii) Atlas Method.

**Source**: Own estimations based on the World Development Indicators database.

### A Distribution Rule for the MERCOSUR

Having a general rule for the distribution of customs revenues could help to resolve the problem of the geographic asymmetries to the extent that a non-geographic criterion is used. With respect to fiscal dependency on customs revenues, if the rule guarantees revenues through collections of duties on extraregional imports greater than or equal to those that were in place before the rule went into effect, then there will be no adverse fiscal effect. Using a distribution rule in relation to the exact offsetting mechanism requires less information and fewer additional customs procedures.

Given that, in the MERCOSUR, the country with the greatest fiscal dependency on customs duties is also the one with the lowest per capita income, a formula was considered that contemplated the objective of convergence in terms of per capita income through transfers from the richer countries to poorer ones.

A comparative analysis with other experiences at an international level, which evidence an analogous situation than that of the MERCOSUR, was made. A distribution rule was adapted, based on those applied by other developing countries that built Customs Unions and had asymmetries similar to those mentioned above. The benchmark considered to this propose, was the case of the Southern African Customs Union (SACU) (See Appendix A). Based on the factors analyzed above, the formula of distribution of customs revenues used by SACU was adapted to the circumstances of the MERCOSUR agreement. The following equation gives the distribution rule for MERCOSUR:

$$RA^{e} = RA^{R}\left(\alpha\,\rho^{e} + (1-\alpha)\,\frac{P^{e}}{P^{R}}\,\frac{((k+1)-(\frac{y^{e}}{y^{R}}))}{k}\right) \qquad (1)$$

Where: the superscript *e* indicates the country (Member State) of reference; the superscript R indicates an aggregate for the region; *RA* = Customs Revenues; $P^{e}$ = the Population of the Member State and $P^{R}$ = the Population for the entire region; $y^{e}$ = the country's per capita income and $y^{R}$ = per capita income for the region, calculated as the sum of all income divided by the total population; $\rho^{e}$ = the scale of the country measured by imports, consumption, or population; $\alpha$ = the proportion of customs revenues distributed by the rule of scale of the country; *k* is a parameter determining the degree of distribution of the rule's relative development component.

The formula decomposes the revenues that will be distributed into two components. The first component (proportion $\alpha$) bears in mind the scale of the country ( $\rho^{e}$). The second component (1 - $\alpha$ ) is the deviation in per capita income with respect to the average for the region. Deciding upon the weighting factor ( $\rho^{e}$ ) is of the utmost importance. The weighting

by country can be accomplished with any of the rules used for the simple distribution alternatives presented in the preceding section (population; consumption; total, extraregional, or intraregional imports).

Small economies are considered in three alternatives ways under the distribution formula. In the first term, the criterion for distributing common customs revenues according with (creo que corresponde to en vez de with) intraregional imports shares, gives greater weight to economies of smaller size that participate relatively more in intraregional trade as compared to an economy that is larger with a relatively lower level of development. In the second term, for parameter $\alpha$ , the smaller this parameter, the greater the proportion of revenues from special domestic taxes that will be distributed in accordance with (or to?) a formula responding to asymmetries in per capita income levels. Finally, parameter $k$ modulates distributive intensity in line with the chosen response to relative levels of development. If this parameter is very large, then this term tends towards equidistribution, reducing the importance of the magnitude of the deviation. On the other extreme, as the parameter $k$ tends to one, the distribution becomes more favorable for the poorer economies. The calculations made have used a parameter of $k=1$.

A simulation was conducted using alternative rules of distribution. Table 12 presents the results of this simulation, which is performed by using the rule proposed in Equation (1). For purposes of calibrating the weighting information with the relevant magnitudes and

Table 12

**Structure Contributions to Customs Revenues and Alternative Weightings for the Distribution Formula, Average: 2000, 2001 and 2003** (%)

| | **Argentina** | **Brazil** | **Paraguay** | **Uruguay** |
|---|---|---|---|---|
| Contributions to the fund (%) | 25.3 | 69.4 | 2.3 | 2.9 |
| Population (%) | 17.2 | 79.0 | 2.3 | 1.5 |
| Deviation in per capita income (ratio) | 1.70 | 0.86 | 0.33 | 1.40 |
| | | | | |
| a) Total imports | | | | |
| Distributed revenues | | | | |
| • simple rule ( $\alpha$ =1) | 22.3 | 71.5 | 2.7 | 3.5 |
| • adjusted for per capita income ( $\alpha$ =0.75) | 18.0 | 76.2 | 3.0 | 2.8 |
| Estimated transfer | | | | |
| • simple rule | -3.1 | 2.1 | 0.4 | 0.6 |
| • with adjustment for per capita income | -7.4 | 6.7 | 0.7 | -0.1 |
| b) Extraregional imports | | | | |
| Distributed revenues | | | | |
| • simple rule | 19.6 | 76.7 | 1.5 | 2.3 |
| • with adjustment for per capita income | 15.9 | 80.0 | 2.1 | 2.0 |
| Estimated transfer | | | | |
| • simple rule | -5.8 | 7.2 | -0.8 | -0.6 |
| • with adjustment for per capita income | -9.4 | 10.6 | -0.2 | -0.9 |
| c) Intraregional imports | | | | |
| Distributed revenues | | | | |
| • simple rule | 36.4 | 47.0 | 8.2 | 8.5 |
| • with adjustment for per capita income | 28.6 | 57.7 | 7.1 | 6.6 |
| Estimated transfer | | | | |
| • simple rule | 11.1 | -22.5 | 5.9 | 5.5 |
| • with adjustment for per capita income | 3.2 | -11.7 | 4.8 | 3.7 |
| d) Consumption | | | | |
| Distributed revenues | | | | |
| • simple rule | 29.3 | 67.8 | 0.8 | 2.1 |
| • with adjustment for per capita income | 23.2 | 73.4 | 1.6 | 1.8 |
| Estimated transfer | | | | |
| • simple rule | 3.9 | -1.6 | -1.5 | -0.8 |
| • with adjustment for per capita income | -2.1 | 3.9 | -0.7 | -1.1 |
| e) Population | | | | |
| Distributed revenues | | | | |
| • simple rule | 17.2 | 79.0 | 2.3 | 1.5 |
| • with adjustment for per capita income | 14.1 | 81.8 | 2.7 | 1.4 |
| Estimate transfer | | | | |
| • simple rule | -8.2 | 9.5 | 0.1 | -1.4 |
| • with adjustment for per capita income | -11.2 | 12.3 | 0.4 | -1.6 |

**Source**: The author.

with the contribution of each country to customs revenues, simple average information was used from the years 2000, 2001, and 2003.[39]

Deviations were considered in per capita GDP using current dollars in relation to the regional average for the years 2000, 2001, and 2003. Two values were considered for the parameter $\alpha$ (1 and 0.75). When $\alpha$ equals one, then the simulation reproduces the results of applying the simple rules referred to above (distributing alternatively by population, consumption, or imports). Estimates were made of collections of customs revenues corresponding to the *status quo*. These revenues would be the ones that the countries should give up in order to comply with the distribution rule.

The largest economy of the bloc would prefer a distribution rule based on population and extraregional imports. In contrast, Argentina would benefit by considering a distribution rule based on consumption (approximated based on production). The smaller economies (including the Argentina), however, would prefer to have intraregional imports considered as weighting factor. The poorer economies (Paraguay and Brazil) are always better off when the term is incorporated that bears in mind deviations in per capita income is introduced, while for the richer economies (Argentina and Uruguay), the opposite is true.

If it were considered desirable that transfers among the Member States be minimal in relation to the current situation, then, from an overall point of view, the alternative of distributing by consumption would be the most satisfactory. In fact, the formula that makes the smallest transfer would be the one based on consumption, with a weighting of the development objective of less than 75%. Nonetheless, this formula would be unsatisfactory to the extent that the poorest, landlocked economy, which is also dependent upon fiscal revenues from duties, would find itself making a net transfer.

Table 13 was designed by combining the various asymmetries considered when analyzing the distribution rules. For each of them, two values were established. This is a very schematic approximation whose sole purpose is to highlight certain facts. Strictly speaking, for most of the factors considered, the variation is continual, and such differences should also be considered.

In the case of size, population was considered: the large countries are the ones whose population is above average for the bloc; the small countries are the ones whose population is below average for the bloc. For wealth, per capita income was considered: the rich countries have incomes higher-than-average for the bloc and the poor countries have incomes lower-than-average for the bloc. For fiscal dependency, a threshold was established to define whether the country had a fiscal dependency upon extraregional import taxes (more than 10% of current revenues). Finally, with respect to geography, two categories were established: with an outlet to the sea and without one. The variables shown in Table 13 were ordered in such a way that the countries most favored are found in the upper left-hand corner, and the poorest countries are found in the lower right-hand corner.

[39] The year 2002 was not considered. In fact, it was understood that 2002 was exceptional from a macroeconomic point of view for many of the region's countries. It is necessary to make an in-depth analysis of that period for the calculations, given that the results could change significantly due to the major oscillations in relative prices during that time.

Table 13
**Comparison in the Distribution of Asymmetries between the SACU and MERCOSUR**

a) Case of the SACU

| | Size | Large | | Small | |
|---|---|---|---|---|---|
| Wealth | Fiscal dependency /Geography | Without fiscal dependency | With fiscal dependency | Without fiscal dependency | With fiscal dependency |
| Rich | Not landlocked | South Africa | | | |
| | Landlocked | | | Botswana | |
| Poor | Not landlocked | | | | Namibia |
| | Landlocked | | | | Lesotho Swaziland |

b) Case of MERCOSUR

| | Size | Large | | Small | |
|---|---|---|---|---|---|
| Wealth | Fiscal dependency /Geography | Without fiscal dependency | With fiscal dependency | Without fiscal dependency | With fiscal dependency |
| Rich | Not landlocked | | | Argentina Uruguay | |
| | Landlocked | | | | |
| Poor | Not landlocked | Brazil | | | |
| | Landlocked | | | | Paraguay |

**Source**: The author.

As mentioned above, there are similarities between the SACU and the MERCOSUR in terms of the distribution of asymmetries. Yet it is also possible to identify differences. These differences are relevant when developing a mechanism for transfers among the members of the bloc. The case of the SACU is almost an archetype in the sense that such transfers must take place, insofar as there are countries on the opposite ends of the table. In the MERCOSUR, in contrast, the principal obstacle is that the largest economy is not the richest, although there is indeed one country clearly situated in the lower right-hand corner of the table. The richer countries are small (even Argentina if its population is considered) and the capacity of generating transfers to the rest of the countries is very limited.

## V. CONCLUSIONS

The integration process, as of 2005, started to head in the direction of a Customs Union, beyond the process of convergence on the CET. Indeed, a recent CMC Decision established the concept of free circulation, modifying the rules of circulation in intraregional commerce. A gradual application was chosen, which, in a first stage, will only include those goods whose inclusion has no fiscal effect (list of 0% CET and 100% common preference). In a second stage, once three basic requirements are met (a MERCOSUR Customs Code, customs interconnection, and distribution of revenues) a schedule will be established to universalize the rule to all goods. The change in the rules of circulation is significant, since, considering

asymmetries in the sizes of the markets, the smaller economies are harmed by the *status quo,* which maintains the Rules of Origin for intraregional commerce.

Progress in establishing definitions for the allocation of common customs revenues has been slower. As specified in the schedule for applying the rule of free circulation, a three-year term has been set to find a solution to this issue. Three alternatives routes have been identified with respect to allocation of the common revenues: an exact fiscal offset in which a charge is made in accordance with destinations of extraregional imports; distribution in accordance with some general rule that approximates the scale of the countries and/or any other objective; capitalization of a common fund to finance shared policies and integration institutions.

The alternative chosen would depend on the objective pursued by the integration process in question. One objective might be that the changes in the rules of circulation associated with the functioning of the Customs Union will be neutral from a fiscal point of view not affecting the public finances of the Member States. Another objective would be to use the distribution mechanism to create some type of transfer system between one type of country and another (rich/poor, large/small). Finally, a third objective might be to create a fund to finance shared policies favoring the integration process.

The abstract alternatives do not correspond to the concrete solution that the MERCOSUR is adopting in this regard. In fact, the MERCOSUR's approach is not a pure and simple one that can be classified within any of the general alternatives defined above. Recent events shows that the strategy implicitly adopted was to separate discussions on how to create a fund for financing shared policies from discussions on what to do with customs revenues. Accordingly, it was decided to create a small fund (approximately 100 million dollars) with contributions from the countries and with certain guidelines for distributing its allocations among them. The problem is now one of what to do with those funds.

With respect to the allocation of common customs revenues in the MERCOSUR, the main concern is focused on the necessary fiscal neutrality that the changes in circulation must have, considering the asymmetries that characterize the countries and potential prejudicial effects to any of them.

Asymmetries among MERCOSUR countries have multiple dimensions that need to be considered. Accordingly, the allocation of customs revenues should bear in mind the differentiated effects (increases or decreases in economic disparities) that such measures could have. The asymmetries borne in mind are: fiscal dependency on import duties; geographic asymmetries; and asymmetries in relative development and in size.

MERCOSUR includes one country (Paraguay) with a high fiscal dependency on duty revenues corresponding to imports from the rest of the world. That country also has a landlocked geography. Furthermore, it is a small country and has the lowest per capita income. Any distribution mechanism must pay special attention to that case. Another particularity to bear in mind is that the largest country with the largest market size is not among the richest countries of the bloc in terms of income per capita. For this reason, the formula of the SACU, when adapted to the case of the MERCOSUR, does not yield entirely

satisfactory results with respect to the general rule of distribution selected. This is an issue that must be analyzed more extensively in the future.

In a certain sense, the discussion on the allocation of common funds is at least partially analogous to the one on the distribution of customs revenues, as far as the consideration of asymmetries is concerned. The fundamental difference lies in the fact that once common funds are generated, it is possible to address community issues that simultaneously impact several countries, without any particular country necessarily appropriating the common funds. The institutional density associated with one option or another differs, in terms of both the quantity and quality of the community institutions. Nonetheless, all the options explored would increase the size and improve the quality of the common institutions.

## List of Abbreviations

| | |
|---|---|
| CAM | MERCOSUR Customs Code (*Código Aduanero del MERCOSUR*) |
| CET | Common External Tariff |
| CMC | Common Market Council |
| CTP | Common Trade Policy |
| EEC | European Economic Community |
| EU | European Union |
| FOCEM | MERCOSUR Structural Convergence Fund* |
| HLG | High-Level Group |
| INTAL | Institute for the Integration of Latin America and the Caribbean ( |
| ITD-IADB | Integration, Trade, and Hemispheric Issues Division of the Inter-American Development Bank |
| MERCOSUR | Common Market of the South |
| MTC | MERCOSUR Trade Commission |
| RO | Rules of Origin |
| SACU | Southern African Customs Union |
| SAT | Technical Advisory Sector (*Sector de Asesoría Técnica*) |
| SM | MERCOSUR Secretariat |

* Translator's Note: This acronym comes from the Spanish and Portuguese: *Fondo para la Convergencia Estructural del Mercosur* or *Fundo Para a Convergência Estrutural do Mercosul*, respectively.

**Appendix A**

# A Case of Interest: Distribution of Customs Revenues in the SACU[40]

The Southern African Customs Union (SACU) is a case of interest, since it is comprised by several Southern African countries, some of which combine the series of asymmetries that characterize MERCOSUR in terms of geography, fiscal dependency on customs revenues and differences in relative levels of development. The origins of this Customs Union date back to the start of the twentieth century, but the most recent event is an agreement between Botswana, Lesotho, South Africa, and Swaziland in 1969. In 1990 Namibia joined the agreement. A new agreement was signed in the year 2002 that sought to overcome the major criticisms of the previous agreement of 1969. One of the core aspects of the agreement involves the distribution formula for common revenues.

Both Lesotho and Swaziland are landlocked countries, which places them in a subordinated geographic relationship with the other trading partners. Furthermore, the public finances of three of the five countries depend upon the transfers they receive from the SACU. In fact, Swaziland, Lesotho, and Namibia obtain a large part of their fiscal revenues from this source (54.1%, 51.0%, and 30.4% respectively). Finally, according to data from the year 2000, Botswana and South Africa are the countries with the highest per capita income (US$ 3424 and US$ 2864 respectively). At the other extreme Swaziland has a per capita income of US$ 1308 and Lesotho's per capita income was only US$ 407, making it one of the poorest countries on the planet. Namibia is in an intermediate position (per capita income of US$ 2006).

As can be concluded from this synthesis, certain analogies can be made between the problem of distributing revenues in the SACU and in the MERCOSUR. It is for this reason a more detailed study of the customs revenues distribution formula used by those African countries is helpful. The distribution equation follows a complex mode, combining several criteria.

$$RA^e = RA^R_{..} \left(\frac{M^e_{.R}}{M^{.}_{.R}}\right) + \alpha ID^R \frac{Y^e}{Y^R} + (1-\alpha) ID^R \frac{\left((k+1) - \left(\frac{y^e n}{\sum_e y^e}\right)\right)}{nk} \tag{A.1}$$

Where: the superscript *e* indicates the country (Member State) of reference; *RA* = Customs Revenues; the superscript R is the aggregate for the region; $M^e_{.R}$ = imports of Member State *e* as a proportion of the imports of all products (.) that are a regional in origin (R); *ID* = special domestic taxes that also enter in the distribution; $\alpha$ = the proportion of domestic taxes distributed by the production rule; e = production per capita; *n* = number of countries in the

[40] For the development of this sub-section Kirk and Stern were used (2003) and WTO (2003).

trade agreement; $k$ is a parameter determining the degree of distribution of the rule's relative development component.[41]

The procedure starts by calculating the aggregated revenues to be distributed, which are comprised by two different sources: the totality of the customs revenues of the SACU ($RA^{R}_{..}$), and a series of special domestic taxes ($ID^{R}$) that also feed the pool of revenues to be distributed. This tax revenue of the SACU is divided among the member countries in accordance with three criteria (See Equation A.1):

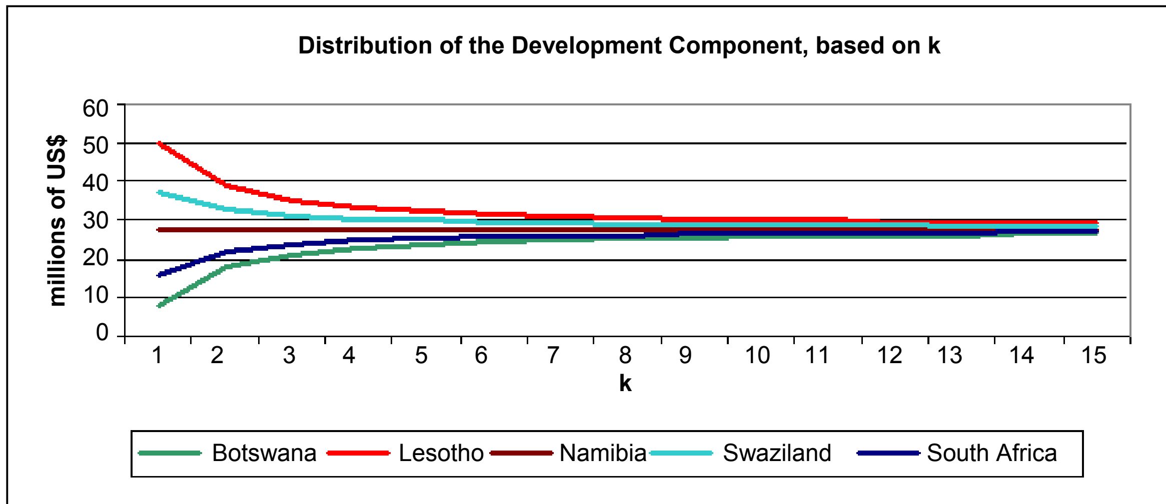
i. In the first term, the customs revenues are distributed based on the participation of the countries in the intraregional commerce of the block ($\frac{M^{e}_{.R}}{M^{.}_{.R}}$).

ii. The second criterion is to distribute a fraction of the special domestic taxes ($\alpha ID^{R}$) in accordance with participation in production ($\frac{Y^{e}}{Y^{R}}$).

iii. Finally, the other fraction of the special domestic taxes are distributed ($(1-\alpha)ID^{R}$) based on a criterion set in accordance with the deviation in the relative level development of each country in relation to the average level of the zone.

Graph 1

**Development Component in the Rule of the SACU**




**Source**: The author, based on Kirk and Stern (2003).

[41] A minimum value of the parameter k needs to be defined, such that numerator of the fraction of the third term of equation (1) will be positive. Therefore, the minimum value for k will depend upon the degree of asymmetries in the relative levels of development of the member countries.

The economies that are smaller in size, with a lower relative level of development are considered in three different ways in the distribution formula. In the first term, the criterion of distributing customs revenues based on intraregional commerce gives greater weight to economies of lesser size that participate relatively more in intraregional commerce as compared to the larger economy (South Africa). In the second term, for parameter $\alpha$, the smaller this parameter, the greater the proportion of revenues from special domestic taxes that will be distributed in accordance with a formula responding to asymmetries in per capita income levels. Finally, parameter $k$ modulates distributive intensity in accordance with the chosen response to relative levels of development. If this parameter is very large, then this term tends towards equidistribution, reducing the importance of the deviation's magnitude. On the other extreme, as parameter $k$ tends to one, the distribution is greater for the poorer economies (See Graph 1).

Considering the MERCOSUR's situation and taking into account there are no domestic tax revenues to be distributed, the only thing that could be distributed are common customs revenues. In the long term, with a universal rule of circulation, customs revenues will be the revenues based on the Common Trade Policy (CTP) of the Customs Union. In the short term, with a more restricted rule of circulation, a precise definition of the revenues to be distributed is needed.

Table A1

**Production, Population and Per Capita Income in the Countries of the SACU**

(Millions of US$ and Millions of Persons)

| | Production | Population | Production per capita (US$) |
|---|---|---|---|
| Botswana | 5.65 | 1.7 | 3424 |
| Lesotho | 0.88 | 2.2 | 407 |
| Namibia | 3.47 | 1.7 | 2006 |
| Swaziland | 1.28 | 1.0 | 1308 |
| South Africa | 125.6 | 43.9 | 2864 |
| Total | 136.88 | 50.42 | 2001.8 |

**Source**: The author, based on Kirk and Stern (2003).

Table A2

**Distribution of the Pool of Revenues in the Countries of the SACU, by Component, for the Year 2002**[42]

(millions of US$)

| Component/Country | Botswana | Lesotho | Namibia | Swaziland | South Africa | Total |
|---|---|---|---|---|---|---|
| CUSTOMS REVENUES | 225 | 113 | 210 | 123 | 173 | 844 |
| Production | 28 | 5 | 17 | 7 | 730 | 787 |
| Development | 26 | 30 | 28 | 29 | 26 | 139 |
| Total | 279 | 148 | 255 | 159 | 929 | 1770 |
| Participation in Distribution (%) | 15.7% | 8.4% | 14.4% | 9.0% | 52.5% | |
| Participation in Production (%) | 4.1% | 0.6% | 2.5% | 0.9% | 91.8% | |

**Source**: The author, based on Kirk and Stern (2003) .

[42] An average exchange rate for the year 2002 was used of 10.23 Rands = 1 $US.

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