The Potential Impact of Economic Integration on Fiscal Policy Operations in Lesotho

By

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Abstract

The World economy is adopting economic integration as a tool to lead developing countries out of maladies such as poverty. The Southern African Development Community (SADC) is not an exemption, with a clear roadmap leading to a single Central Bank. However, the initiative does not have the same benefits for all Member States. The study, therefore, aimed to establish how Lesotho will be affected by the integration. It is revealed that Lesotho derives about 45 per cent of revenue from SACU inflows, and that the country exports minimally in the region. Furthermore, tax performance test results reveal that the elasticity of revenue to national income is more than unity. This implies that if the country loses fiscal revenue, there is a potential to recover it through other macroeconomic initiatives. This is supported by empirical literature, which confirmed that about 30 per cent of revenue is recovered after the reforms. It is therefore concluded that economic integration can ignite other dormant macroeconomic variables. Context

Keywords: Fiscal Policy, Tax Revenue, Tax performance, Tax buoyance,

JEL Classification: E62, H21, H5, H6, G23, G24, O16. ,

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Table of Contents

1. Introduction

1.1 Background

The global economy is moving towards creating trading blocks for market expansion and product diversification. It is, however, acknowledged that the initiative benefits countries to different degrees, depending on the level of economic development. Smaller economies are often victims to shrinking fiscal resources. The Southern African Development Community (SADC) is no exemption to these trade initiatives. The year 2008 saw implementation of SADC Free Trade Area (SADC-FTA), with Customs Union scheduled for the year 2010, Common Markets in 2015, Monetary Union in 2016 and single Currency in 2018. It is, therefore, important to assess the implications of the free trade agreement and Customs Union on Lesotho's fiscal policy operations.

Lesotho has a unique and complicated policy environment. The country is a member of a number of international and regional organisations. It is through this membership that independence of some policies and policy instruments is either compromised or lost. Of more relevance are, the Common Monetary Area (CMA) arrangement, the Southern African Customs Union (SACU) and SADC. Lesotho shares SACU membership with Botswana, Namibia, South Africa and Swaziland. With the exception of Botswana, the quartet also shares membership of CMA, with the South African rand circulating, parallel with the respective local currencies, as a legal tender in the smaller member states. As a result of the CMA membership, Lesotho has lost independence of the monetary policy, a responsibility which rests with the South African Reserve Bank. For that reason, fiscal policy remains the only relevant policy for macroeconomic stability, with limited instruments to play with, due to her membership in SACU.

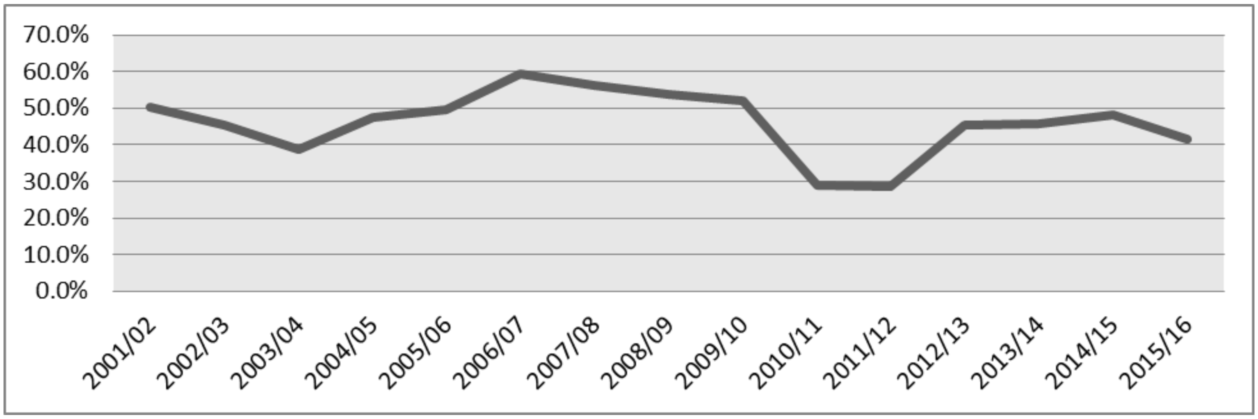
Fiscal policy is the means by which a government adjusts its levels of spending and/or revenue in order to influence a nation's economy. It is a government policy that attempts to influence the direction of the economy through changes in government taxes, or through spending adjustments. The general terminology used for taxation and the other sources of financing is revenue, which refers to the gross proceeds received from taxes, fees, and other charges. A tax is a financial charge or other levy imposed on an individual or a legal entity by a state or a functional equivalent of a state (for example, secessionist movements or revolutionary movements). It is not a voluntary payment or donation, but an enforced contribution, exacted pursuant to legislative authority and is imposed by government whether under the name of toll, tribute, impost, duty, custom, excise, subsidy, aid, supply, to mention but a few.

Government revenue is classified into revenue from taxes on international trade and domestic tax revenue depending on its source. Understanding this is particularly important in the case of the current trade arrangement for Lesotho. Of the members of SACU, Lesotho is the poorest with skewed dependence on remittances from the SACU revenue pool. This makes her highly vulnerable to any policy change that may be effected by the union. It also explains vulnerability of its economy to external shocks.

1.2 Trends in Government Finances

Due to her relative level of development, Lesotho receives the highest share from the development component of the SACU revenue, which makes this the single largest source of government revenue. This has averaged 46.1 per cent of total revenue collections during the period 1991/92 to 2001/16, reaching a peak of 60 per cent in 2006/07, as depicted in Figure 1 below. Revenue from the other sources has improved over the period, averaging just over 17 per cent growth rate a year in nominal terms. This improvement was mainly on account of the establishment of Lesotho Revenue Authority (LRA), which saw efficiency in tax collections, supported by introduction of value added tax (VAT) at a rate of 14 per cent in 2003, in place of the general sales tax which was levied at 10 per cent. VAT also has a broader base than the former. This tax component averaged 37.1 per cent during the period under review, reaching a maximum of 44.5 per cent in 2011/12.

Figure 1: Customs as Percentage of Total Revenue



Source: Central Bank of Lesotho

The other components of revenue (both tax and non-tax revenue), all combined, contributed less than SACU revenue, until 2011 and hence forth. This makes Government budgetary operations highly exposed to external shocks. It is upon this realisation that the study is being conducted. It is important to establish how Lesotho's budgetary operations can benefit from SADC-FTA in terms of product diversification and markets.

The rest of the paper is organised as follows: Section 2 reviews literature on the emergence of trade liberalisation on fiscal policy. Section 3 presents analytical perspective, while section 4 concludes and suggests policy recommendations.

1.3 Objectives

The study aims to assess the possible impact of economic integration on the Government fiscal policy. This will specifically evaluate the impact of this on government budgetary operations, and its link with the other macroeconomic variables, and draw policy recommendations from the findings.

2. Theoretical Debate

2.1 Emergence of Trade Liberalisation

Free trade is defined as a system in which trade in goods and services between or within countries flows without government-imposed restrictions. Such government interventions generally increase costs of goods and services to both consumers and producers. Dornbusch et at (1977) define protectionism as a means of attempting to ensure that domestic industries are protected from competition from foreign producers and can be carried out through a variety of means, such as;

> *Tariffs, which raise the price of goods coming into a country, quotas - a physical limit on the number of goods that can be brought into a country, and other non-tariff barriers such as regulations and legislation that make it very hard for foreign competitors to sell goods into another country.*

The great depression of the 1930s stimulated growth of international trade by reducing these trade barriers. It was during that period that the General Agreement on Tariffs and Trade (GATT) was initiated as a negotiation tool to reduce tariffs on imported goods on a reciprocal basis. Countries recognise the importance of trade to instil efficiency. As a result, trade liberalisation has come in different forms, such as the regional free trade agreement, to make use of comparative advantages. This has facilitated establishment of regional trading blocks around the world. Countries aspire to promote interdependence and connectedness with important economic partners since it is argued that free trade raises aggregated economic efficiency, Dornbusch et al (1977).

It is however, advised that liberalisation should be implemented in a way that does not compromise macroeconomic policy such as in government budgetary operations and the external sector. Baunsgaard and Keen (2005) established that trade liberalisation in many developing countries may be hindered unless there are alternative sources of revenue. They have proved that revenue recovery attributed to trade liberalisation mostly benefits high and middle income countries through improvement in collection of VAT.

The least developed countries seemed to recover only around 30 per cent of the lost revenue.

The IMF (2005) also confirmed that some poorer countries have been unable to recover lost trade tax revenues through strengthened domestic taxation. Amongst low-income countries, total tax revenues as a percentage of GDP have on average declined in parallel with trade tax revenues. Middle income countries, on the other hand, have managed to maintain total tax revenues broadly unchanged, while in high income countries they have increased. The full implications of trade reform for government revenue thus depend on a range of considerations, most of which point to a "second-round" increase in overall revenue. These effects are, however, naturally subject to significant uncertainty as to their strength and timing.

2.2 Empirical Evidence on Fiscal Operations

This section presents empirical experience on the benefits of trade tax revenue and the possible impact on liberalisation. Tanzi (2003) established that trade liberalisation affect not just tax revenue but also the role of state in the economy through public spending. His argument was dependent on the level of revenue recovery. If recovery is less than the foregone component, then Government transfer payments and fiscal deficits will be negatively affected. The Economic Commission for Latin America and Caribbean (1999) highlighted that in most small countries, international trade tax revenues account for the largest share of revenue, measured at about 30 per cent in Jamaica in the late 1990s. Therefore, failure to recover it leads countries into unsustainable fiscal position.

In a similar study conducted for the East Africa Community (EAC), Nnyanzi et al (2016) discovered that the EAC regional integration had a significant impact on tax revenue owing to the presence of good institutions. This observation implies that for integration initiatives to benefit member countries, they should be accompanied by deliberate actions with relevant institutions and appropriate legal environment. Accordingly, the study advocated for improvement of institutional environment, financial sector, macroeconomic stability, and manufacturing and trade, as well as a well-integrated approach to reduce a shadow economy. It also encouraged cautious capital control policies to enhance tax collections in East Africa. This was confirmed by Babyenda (2013) whose earlier review had revealed no relationship at all between Uganda's tax revenue and the East Africa Community (EAC) integration.

Wang et al. (2007) acknowledged that trade liberalisation may improve trade competitiveness, and in most cases participating countries benefit in the form of a surge in trade tax revenue. But it is warned that this is more effective when the concerned are in official trading blocks, with harmonised tax and incentive systems. These findings were based on policy environment of the Common Monetary Area in Southern African.

They observed that revenue collected by SACU represented an important institutional mechanism for fiscal transfers across the union's member countries. On average, SACU revenue accounted for 10 – 34 per cent of GDP in Lesotho, Namibia and Swaziland in fiscal year 2004/05. In addition to the impact on fiscal policy, the inflows of SACU revenue are also important for balance of payments. It is, therefore, notified that the role played by this source of revenue could become less important should the ongoing negotiations for free trade agreements between the United States and the European Union be concluded.

Expansion of SACU to include SADC poses threats to fiscal policies of the current quartet. Wang et al (2007) noted that the issue of SADC revenue sharing distribution arrangements and institutions might supersede the SACU revenue sharing mechanism. This was supported by Government of Lesotho (GoL) (2006) that observed that SACU provides Lesotho with its largest single item of fiscal revenue, and an important balance of payments credit. Therefore, the effect of trade liberalisation and SACU tariff reduction might cause the overall revenue pool to stagnate in real terms.

This anticipated decline reflects the impact of general trade liberalisation, which may lead to generally lower customs tariff levels. Slow or negative real growth has important implications for fiscal and balance of payments sustainability. The replacement of SACU by a SADC Customs Union (SADC-CU) has potential to impact negatively on Lesotho. It is not clear whether a SADC-CU would have any redistribution mechanism, which would be shared across a larger number of low income countries. It is important at this stage to review and understand the revenue sharing formula currently in place.

2.3 SACU Revenue Sharing

According to the SACU agreement, as amended in 2002, Member States agree that in determining their respective shares of the total customs, excise and additional duties collected in the Common Customs Area during any financial year, the share accruing to each Member State is calculated from three distinct components as set out below.

Member States agree that the budgeted cost of financing the Secretariat, the Tariff Board and the Tribunal for the related financial year be deducted proportionately from the gross amounts of customs, excise and additional duties collected, before distribution to Member States from the three components mentioned hereunder.

The Customs Component

a) The customs component consists of the gross amount of customs duties and specific and ad valorem customs duties leviable and collected on goods imported into the Common Customs Area, and other duties collected on imported goods, less the deduction as provided for in (b), but excludes any duties rebated or refunded under the provisions of any law relating to customs duties.
b) Each Member State's share of the customs component is calculated from the value of goods imported from all other Member States in a specific year as a percentage of total intra-SACU imports in such year.

The Excise Component

a. The excise component consists of the gross amount of excise duties, less the deduction as provided for in (b), leviable and collected on goods produced in the

Common Customs Area, less the amount set aside to fund the development component, but excludes any duties rebated or refunded under the provisions of any law relating to excise duties.

b. Each Member State's share of the excise component is calculated from the value of its Gross Domestic Product (GDP) in a specific year as a percentage of total SACU GDP in such year.

The Development Component

a. A development component is established and funded from a fixed percentage of the excise component, less the deduction as provided for in (b).
b. Each Member State receives a share of the development component, whose distribution is weighted in favour of the less developed Member States.

It is clear from the foregoing that revenue sharing formula favours the less developed Members States. However, it also encourages Members to improve private sector participation in order to realise more benefits. It is important to also understand the SADC objectives in order to facilitate comparison with SACU.

2.4 SADC Objectives

The objectives of SADC are stated in Article 5 of the Treaty. The objectives emphasise the need to ensure that poverty alleviation is addressed in all SADC activities and that all programmes aim to eradicate it. Nonetheless, HIV and AIDS is recognised as a major threat to the attainment of the objectives and therefore is accorded priority in all SADC programmes and activities.

For the purpose of this study only the relevant objectives of SADC as stated in Article 5 of the Treaty are listed for ease of interrogation. It aims to;

- Achieve development and economic growth, alleviate poverty, enhance the standard and quality of life of the people of Southern Africa and support the socially disadvantaged through regional integration;

- Promote self-sustaining development on the basis of collective self-reliance, and the interdependence of Member States;
- Achieve complementarity between national and regional strategies and programmes;
- Promote and maximise productive employment and utilisation of resources of the Region.

3. Analytical Perspectives

3.1 The Prospects

It is shown on sub-section 1.2 above that trade related revenue accounted for more than 40 per cent of total revenue, in Lesotho, during the period 1991 to 2015/16. It is also revealed from sub-section 2.3 on SACU revenue sharing formula that the allocation tends to favour the poorer member states. Baunsgaard and Keen (2005) confirmed in their panel data that low income countries recover no more than 30 per cent of each dollar lost due to trade liberalisation. Their study also established that low income countries could not recover significant amount of revenue with introduction of VAT.

The empirical literature, further established that the lost trade-related revenue is compensated for with improvement of the institution responsible for tax collection and administration, and to some extent, introduction of VAT. These two measures are already in place in Lesotho. Therefore, it is not going to be easy to recover the revenue that will be lost due to coming into place of the SADC-FTA, and CU. Moreover, with the level of industrialisation in the Non-SACU member states, it is highly likely that the bulk of imports from those countries will mainly be agricultural products, which are immune to VAT. As a result, it will not be easy to get any significant revenue due to the nature of the imports.

In addition, it is important to acknowledge at this stage that with the exception of Mauritius and Seychelles, the rest of SADC-Non-SACU members are low income countries, and most with lower per capita income than Lesotho. This implies that should SADC adopt the same revenue sharing formula as SACU, the share of development component that accrues to Lesotho will definitely contract in the short to medium term.

Furthermore, the free trade arrangement has potential to benefit the Non-SACU SADC members more than will the SACU members with some of their exports getting a wider and bigger market. Nonetheless, for SACU, it might benefit the South African products more in the short run since they already benefit from well established superstructures, and most of the chain stores are already operational in the rest of the region, but only limited by the higher tariffs and quotas. On the positive side, this may facilitate expansion of Lesotho's exports through the South African chain stores to penetrate the region as opposed to the current status and boost the external sector. The next section provides analysis of Lesotho's exports by product and destination.

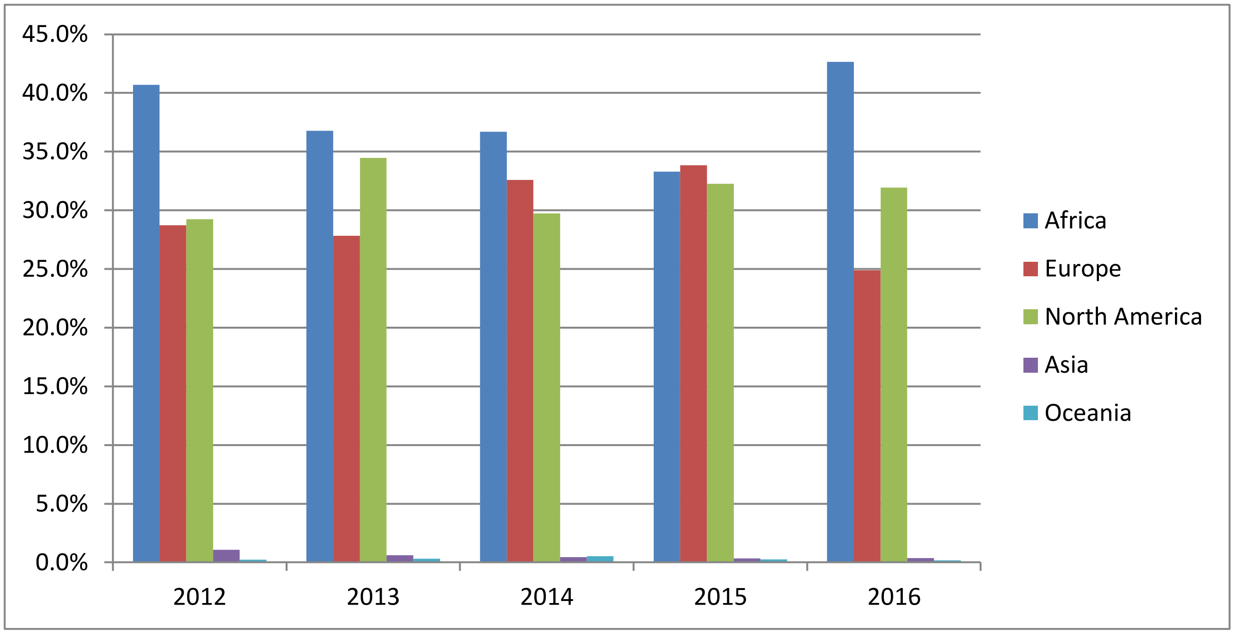
3.2 Lesotho's Products in International Markets and Direction of Trade

Lesotho is predominantly a consumption economy, with bulk of consumables imported from South Africa. The country has failed to take advantage of available opportunities. There are a limited product range available in international markets, and with ownership dominated by foreign companies, and largely, destined to three main global markets, SACU[2], the US, and European Union (EU). This could perhaps be on account of investment capabilities and innovativeness. Therefore, it might not be easy to recover 100 per cent of revenue that would be lost due to the free trade arrangement.

Clothing accessories and diamonds remain the largest exports commodities, followed by agricultural products and beverages. About 37.5 per cent of the exports, on average, were destined to the SACU during the period 2012 - 2016, while US was the second at a share of 31.5 per cent. The third destination is the European market where Lesotho's diamonds are traded at 29.6 per cent. Exports to the rest of the other SADC member states were insignificant at less than 1 per cent. This is represented in figure 2 below.

[2] South Africa takes more than 96 per cent.

Figure 2: Direction of Merchandise Exports



Source: Central Bank of Lesotho

It is also important to acknowledge that other than imports of intermediaries, most of Lesotho's imports are sourced from South Africa. Therefore, the free trade arrangement might enhance competition only on agricultural commodities. Otherwise, the status quo will remain for manufactured imports. It is important to assess the responsiveness of tax revenue to other developments. This is achieved with aid of tax performance assessment in the next sub-section.

3.3 Tax Performance

Tax Buoyancy[3] and Tax Elasticity are useful in quantifying the empirical relationship between tax revenue and income of a state. It is anticipated that the SADC initiatives will facilitate economic growth of respective member states, and thus, their respective revenue. Therefore, it is important to establish whether the same hold for Lesotho. For the purpose of this study, both tax effort index and tax buoyancy are used to determine tax performance. Tax effort is regarded as the expected tax yield given a country's

[3] Tax buoyancy refers to responsiveness of tax revenue to tax base including other efforts employed to realise efficiency.

taxable capacity to reflect the effectiveness of raising tax revenue. There are three approaches to calculating tax effort, each is discussed, with merits highlighted in the following subsection.

Approaches to Calculating Tax Effort

a) Traditional regression approach

This approach takes the ratio of the actual tax ratio to the tax ratio predicted by the regression equation. It measures the effectiveness of available tax instruments in collecting taxes, relative to the potential collections of these tax instruments. This approach takes into consideration structural economic features that are likely to affect tax effort by adding economic features related to the tax bases and their relative accessibility to the various administration authorities. It yields an indicator that is clear but that generally has important limitations to inform policy reform.

b) Stochastic Frontier Analysis

Stochastic frontier analysis is an econometrics approach that assumes that tax administration potentially collects less revenue than it might due to a degree of inefficiency. This equates tax revenue to random shocks plus the level of inefficiency, which may include corruption[4].

c) Revenue potential variables

This approach works with the assumption that a country's revenue capacity depends on economic, demographic and institutional factors. It builds on the Stochastic Frontier Analysis and goes further to include GDP per capita, openness, shares of hard-to-tax sectors in GDP (agriculture, services, and construction), inflation rate, income inequality, capital investments, foreign grants, and crude petrol production. In addition, demographic variables, such as, age dependency, population density, and level of education are

[4]According Goodspeed, Martinez-Vazquez and Zhang in Cyan at el (2013) Corruption may lower the burden of corporate taxes

included in the model. Corruption is included to account for the country's institutional setting.

For the purpose of this study, traditional approach was adopted for its simplicity. According to Teera (2004), tax ratio index that is less than unity implies that country exploits its estimated tax potential less than the average, while that above unity implies that country is making use of the tax base to increase revenue. A high value of tax effort index indicates that a particular country is collecting more tax than would be predicted, given its tax structure and prevailing economic and social conditions. A combination of a high tax ratio and a high tax effort index suggests that potential for further tax increases would be limited.

It is also important to ascertain whether a country has made efforts over a period to increase tax revenue. This is achieved through either tax buoyancy or elasticity. This displays the extent of the sensitivity and response of the tax system to the changes that take place in the composition and value of GDP. Tax buoyancy is calculated by use of the regression equation for tax revenue on national income. Table 1 below presents tax performance results.

Table 1: Tax performance

Description	Ratio
Tax Ratio	36.8
Tax Effort Index	2.536
Tax Buoyancy	1.95

Source: Teera J. M. (2004)

Results on table 1 above are consistent with developments in tax administration in Lesotho. It is mentioned on the above sections that Lesotho has already put in place revenue administration mechanism to realise efficiency, with VAT replacing the general sales tax in the year 2003. Table 1 confirms that Lesotho has the necessary measures in place to realise improvement in tax revenue. This is reflected by the tax effort index of 2.5, which is more than unity.

Moreover, the tax buoyancy of more than unity also implies that a unit increase in GDP is translated into more than a unit increase in tax revenue. This implies that any efforts introduced to enhance the national income will result in higher tax revenue (195 per cent increase in tax revenue). This is further confirmed by Koatsa and Nchake (2017) whose results acknowledged that Lesotho's tax system were elastic. Otherwise, there is limited room to stimulate more growth in tax revenue. Consistent with SADC objectives of increasing both national and regional output, Lesotho needs to focus more attention on efforts to improve the national output if revenue enhancement is to be realised.

4. Conclusion

It is established from the above discussion that the SADC-FTA and the envisaged SADC-CU have potential to impact on Lesotho's fiscal policy operations[5]. The study looked at the composition of Lesotho's exports and their destination with a view to determine possibility of expansion and potential for more trade related tax revenue. It revealed that the current composition has a limited market, since it is mainly dominated by clothing and textiles, whose driving force has been the African Growth and Opportunity Act (AGOA) of the United States. This, therefore, means the envisaged integration may have negative impacts of government revenue.

However, not all is lost. A further analysis employing the Tax Buoyancy[6] and Tax Elasticity technique provide some slim optimism. This established that there is potential to generate revenue by boasting domestic economic activities. The elasticity of revenue to national income is more than unity, implying that a unit increase in economic growth may result in more than a unit increase in tax revenue.

[5] It was not yet easy to quantify the impact due to data availability.
[6] Tax buoyancy refers to responsiveness of tax revenue to tax base including other efforts employed to realise efficiency.

The fluctuations in revenue, as a result, may stimulate development of financial markets in the country. The financing gap may be sourced from all potential financiers including domestic money and capital markets. As a consequence, the auction amount will increase in line with the financing requirements, while the auction frequency will still be determined by liquidity management needs. For that reason, the fiscal operations will complement activities and operations in the financial markets.

5. Policy Recommendations

a) It is therefore, imperative for policymakers and Lesotho National Development Corporation, in particular, to review the strategy to attract new entrants that will explore the alternative market. This, therefore, means that domestic economic activities may enhance domestic tax revenue.

b) Government should also address measures that facilitate growth of national income in order to realise higher tax collections. This could be by putting in place legislation and policy measures that facilitates establishment and growth of the private sector, with supporting infrastructure and human capital.

c) It is also imperative to review and address all rigidities in the government regulatory framework that may hamper business operations. This includes relevant legislation, policies and necessary infrastructure, if the country is to benefit from the initiatives.

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