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Technical Report:

Swaziland Trade Policy Options: SACU Priorities

Frank Flatters
Robert Kirk

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P.O. Box 602090 ▲Unit 4, Lot 40 ▲ Gaborone Commerce Park ▲ Gaborone, Botswana ▲ Phone (267) 390 0884 ▲ Fax (267) 390 1027

E-mail: info@satradehub.org

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EXECUTIVE SUMMARY

As a small, landlocked economy, Swaziland faces special challenges in competing efficiently in global and regional export markets. Meeting these challenges will be critical in achieving her long-term economic development goals. Membership of the Southern African Customs Union (SACU) plays a pivotal role in Swaziland's public finances and in linking her economy with the region and the rest of the world. It offers duty free access to South Africa, determines a large part of external trade policy, and accounts for more than two thirds of total government revenue.

But SACU is not working as it should in promoting the economic development and regional integration of its members. The SACU Common External Tariff protects selected uncompetitive producers in South Africa while raising the costs and reducing the competitiveness of new and more competitive producers elsewhere in SACU. The system for revenue sharing makes Swaziland excessively dependent on an unstable and unpredictable revenue source, and presents her with an unnecessary and very unproductive and costly conflict between short-term fiscal revenue needs and longer-term economic development requirements. Finally, insufficient coordination and cooperation among SACU members in basic tax and trade administration and in a wide range of regulatory and other policies result in a costly web of impediments to trade and investment that serve only to raise costs and reduce competitiveness of investors throughout the customs union.

Exporters require access to inputs at globally competitive prices and effective access to major markets both regionally and globally. The prices of all goods produced and consumed in Swaziland are affected by the SACU Common External Tariff (CET), which has been developed to protect a subset of generally uncompetitive South African producers and to follow a development model whose usefulness for South Africa is moot and whose effects on an economy like Swaziland's is almost certainly harmful.

For Swaziland, the anti-export bias resulting from the CET is mitigated in part by exports of a few key products on preferential terms (European Union (EU) and African Growth and Opportunity Act (AGOA)); however trade developments threaten to erode these preferences. The reform of the EU Common Agricultural Policy and the removal of quotas for sugar under the Everything But Arms (EBA) will drive export prices down. At the World Trade Organization (WTO) level least developed countries (LDC) demands for DFQF access to developed country economies will devalue AGOA preferences.

Swaziland's future development depends on becoming competitive in some non-traditional exports. Identifying what product or products these might be is not a task for government officials or politicians. But government has a critical role to play in creating a domestic business environment and a trade policy framework that facilitate increased efficiency and reduced transactions costs in regional and international trade. The significant number of high rates and the overall complexity of the SACU CET are becoming increasingly recognized as a major barrier to export competitiveness. No less important are a wide range of other formal and informal barriers to trade among SACU members, most of which violate the most basic principles of any customs union.

To be competitive going forward Swaziland will need to ensure increased efficiency and reduced trade costs. This requires improvements in the domestic enabling environment and liberalization of the SACU CET.

Swaziland is heavily dependent on revenue from the SACU to maintain the government budget. Initial concerns that SACU revenue would decline, following the renegotiation of SACU and the implementation of the Trade and Development Cooperation Agreement (TDCA) with the EU, have not materialized. As predicted from the beginning, however, these revenues have been unstable and unpredictable. Until recently this instability has at least superficially worked in Swaziland's favor due to an unexpected boom in highly taxed South African motor vehicle imports. This caused not only an upward trend in annual customs revenues, but also recurring additional payments in subsequent years, as previous revenue underpayments were made good. While this certainly produced welcome revenue windfalls, it also carried the danger of encouraging an unnecessary cavalier approach to fiscal discipline.

While the concerns about future reductions in SACU revenue transfers were mistimed they were not wrong. The South African import boom that fuelled the revenue pool is now in reverse. This is reflected in Swaziland's most recent budget, which forecasts a small decline in SACU revenues next year. However, the current estimates are almost certainly unrealistic. Just as the previous boom led to an acceleration in revenues, the decline that is now in motion will also accelerate, if for no other reason than the need for negative adjustment payments in the next several years arising from overestimates of SACU customs revenues. **Commencing in April 2010 Swaziland faces a serious reduction in SACU revenues. Preliminary estimates indicate that revenues may decline by 15-20 per cent, sufficient to trigger serious adjustment concerns.**

The projected reduction in revenue needs to be addressed now. It is vital that the MOF prepare estimates showing the expected SACU revenues through Financial Year (FY) 2011-2013 under a variety of possible scenarios in order to immediately begin planning an adjustment strategy.

More generally, the emerging crisis in SACU revenue payments, which will be a serious concern for all four smaller SACU members, presents an opportunity to revisit the 2002 SACU agreement and deal with some of its more unfortunate unintended consequences. Among the most important of these is the excessive dependence of Botswana, Lesotho, Namibia and Swaziland (BLNS) revenues on the SACU tariff and on South African imports of highly taxed goods. Solving this problem requires a distinction between pure customs and excise revenue sharing, on the one hand, and redistributive and developmental transfers and programs on the other. Development in SACU should not depend on one of its key impediments, the unfair and antidevelopmental SACU tariff. Two of the key development priorities should be improving the overall trade and investment environment through rationalization of the tariff and reducing regulatory impediments to SACU trade and investment; and directing public sector resources to well thought out and genuinely developmental investment and infrastructure programs.

Current challenges present an opportunity for the Government of Swaziland to establish the foundations for adjustment and future growth. Specific recommendations include:

- Preparing a detailed assessment of the future government revenue estimates for FY 2011-FY2013;
- Initiating discussions within SACU to renegotiate a new revenue sharing arrangement that is transparent and easy to implement;
- Recognizing the need within SACU for development transfers to ensure stability and encourage more equitable growth throughout the region;
- Prioritizing improvements in trade facilitation and trade policy to reduce trade costs and enable producers to be more competitive in international markets; and,
- Continuing to improve the domestic enabling environment.

The attached paper assesses the current crisis in SACU relations focusing on revenue sharing, redistribution and development, tariff policy, trade facilitation issues and the investment framework.

OVERVIEW AND BACKGROUND

As a small, landlocked country, Swaziland depends heavily on trade relations with both her immediate neighbors and the world at large. Effective participation in the regional and global economies requires efficient and low cost movement of goods and services—both imports and exports—between Swaziland and the outside world. It also requires low cost and reliable means of communication with the outside world.

In this context, Swaziland's membership in the Southern Africa Customs Union (SACU) plays an essential role in her economic development.

- The vast majority of Swaziland's imports and exports pass through SACU. Some of these imports originate in SACU (mostly South Africa), and others originate elsewhere and pass through SACU directly or through South African distribution channels. This has several important implications.
  - The efficiency of transport and logistical arrangements on trade passing through SACU plays a critical role for Swaziland. It affects the cost of goods imported for final consumption or for use as intermediate inputs in production for the domestic, regional and global markets. It affects the competitiveness of goods that might be exported to the region or to the world at large.
  - The prices of all tradable goods produced and consumed in Swaziland are affected by the SACU Common External Tariff. Since Swaziland is generally a consumer rather than supplier of these protected goods, the net effect is harmful for Swaziland. Sugar is Swaziland's only significant export to SACU, and this accounts for about 50 percent of her annual sugar production. While sugar was once quite heavily protected in South Africa, the current tariff is zero—sugar can be imported freely from anywhere in the world. The actual rate that is levied depends on the world price, and comes into effect only when the world price falls below a certain level. The SACU sugar tariff no longer provides significant protection in the SACU market, and so Swaziland gains no significant benefits from preferential access to the SACU market.
- The SACU revenue sharing arrangements agreed in 2002 resulted in Swaziland's public sector budget remaining heavily dependent on revenues from the SACU Customs pool. SACU revenues account for more than two thirds of total government revenue. The bulk of the revenue originates from import duties levied on imports into SACU (primarily South Africa). Thus, while Swaziland's consumers pay higher prices and much of her potential industrial competitiveness is compromised by the relatively high SACU Common External Tariff (CET), the public sector budget is critically dependent on the same tariff. The peculiar nature of the SACU revenue-sharing formula creates a huge (and unnecessary) conflict between Swaziland's longer term development interests, which depend on effective and low cost

integration with the global economy, and her public sector budgetary requirements, which depend heavily on the high SACU tariff.

The other three external trade relationships that have a significant influence on Swaziland's development are those with the European Union (EU), Common Market for Eastern and Southern Africa (COMESA) and the United States of America (USA) (under African Growth and Opportunity Act (AGOA)). Trade under the SADC Free Trade Agreement (FTA) remains relatively small.

Until recently, Swaziland's trade with the EU has been governed by the Cotonou Agreement under which key commodities, primarily sugar, received preferential but quantitatively restricted access to the EU market, and the South Africa-EU TDCA, a reciprocal free trade agreement. Although Swaziland (and the other BLNS countries) are not formal members of the TDCA, their membership in SACU has made them *de facto* parties to the agreement, at least with respect to preferential treatment of imports from the EU.

The non-reciprocal Cotonou Agreement has now expired and is about to be replaced by a reciprocal EPA. For the purpose of negotiating this agreement Swaziland has been a member of the SADC EPA group, comprising the members of SACU plus Angola and Mozambique. Since Swaziland is not a member of the group of Least Developed Countries that benefit from duty-free, quota-free access to the EU market under the Everything But Arms (EBA) preferences, the imminent expiry of Cotonou preferences represented a serious potential decline in market access. This is why Swaziland, along with Botswana, Lesotho and Namibia[1], initialed the EPA in December 2007 despite South Africa's unwillingness to sign because of objections to some of its provisions. The decision of the BLS to sign the EPA in June 2009, without these objections being resolved, created considerable conflict with South Africa's Department of Trade and Industry (this is discussed further below).

Swaziland's membership in COMESA stems from the complex geo-political relationships prior to South Africa's democratic transition. Swaziland has received a derogation that provides for preferential access to selected COMESA countries on a non-reciprocal basis on the understanding that Swaziland will seek to negotiate with SACU to grant preferences. In practical terms, the main impact of COMESA membership is to provide preferential access for Swaziland to certain COMESA markets for a few export commodities, primarily sugar, refrigerators and Coca Cola Concentrate.

AGOA provides tariff-free and quota-fee access to the US market for qualifying African countries. The main benefit for Swaziland arises from exports of garments. In recent years Swaziland has been exporting $125-$150 million worth of garments to the United States (US) under AGOA.

As a "less developed beneficiary country" (LDBC) under the AGOA rules,

[1] Namibia issued a letter registering reservations with the expectation that these would be resolved prior to signing.

Swaziland qualifies for the unrestrictive single stage transformation rule of origin. This enables Swazi garment producers to source fabric and yarn from any anywhere in the world when producing AGOA products. It is interesting to note that the availability of this single stage transformation rule has not prevented the development of local weaving and knitting capacity. In fact, one firm is now investing in organic cotton production for an integrated cotton fiber-spinning-weaving/knitting-dying-garment supply chain. Even for such a highly integrated firm, however, the single stage transformation rule is essential in providing the flexibility necessary to meet demanding buyer requirements in the US market.

SACU – SEEDS OF A CRISIS

SACU is the world's oldest surviving customs union. Its longevity reflects both its value to its members and its robustness in the face of their changing needs and circumstances. Over the past half century it has undergone two extensive transformations to take account of changing geo-political developments.

- In 1969 the Agreement addressed the need to take account of the newly independent countries of Botswana, Lesotho and Swaziland (BLS). Namibia acceded to SACU on the same terms when it became an independent nation in 1990.
- The successful democratic transition in South Africa in 1994 resulted in a new Agreement being concluded in 2002. Major changes at that time sought to address some fundamental inadequacies of the 1969 Agreement. These included the lack of a neutral professional Secretariat to administer the customs union, the lack of an effective voice for the Botswana, Lesotho, Namibia and Swaziland (BLNS) on policy issues, and a revenue sharing arrangement that lacked a rational economic basis.

Today, the SACU faces a further crisis, one grave enough to threaten its very existence. Talk of the break up of SACU has been mooted in the press and the members have recently held a series of Ministerial retreats and meetings which have resulted in a frank exchange of views and a renewed commitment to try and resolve outstanding disagreements.

The crisis arises for two reasons—the EPA negotiations with the EU, which exposed dangerous frictions and apparent conflicts in the interests of different member states; and the SACU revenue-sharing formula which, until now, has yielded unexpected revenue windfalls to Swaziland and the three other smaller member states, but now threatens a potentially precipitous reversal, exposing Swaziland these other three to the risk of a serious fiscal crisis.

While it certainly is tempting to view this in a negative and/or threatening way, a more fruitful approach might be to regard this as an opportunity to assess the real value of SACU, not only as it operates at present, but also as it might work under different configurations. Can the current crisis be seized as an opportunity to re-examine the true potential of the union to assist members to achieve their long-term development goals? Within such a framework it might be possible to deal not only with the immediate flashpoints, but also other

fundamental questions that underlie this heretofore-robust institution.
If SACU is seen to have some significant potential value to its members, how best can its institutions and operations be reconfigured to unlock this potential?

EPA Negotiations

The current crisis has been precipitated most immediately by the decision of the four smaller economies—BLNS—to initial an Economic Partnership Agreement (EPA) with the EU (in December 2007) and therefore to commit to breaching the SACU CET. Although it should be noted that Namibia issued a letter registering reservations about the draft agreement and proceeded with the negotiations on the understanding these would be resolved prior to the formal signing. When they were not resolved only the BLS signed the agreement in June 2009.

The purpose of the EPA negotiations is to replace tariff and trade preferences previously granted by the EU to developing countries on a non-reciprocal basis, with a system of preferences that are *reciprocal* and thus World Trade Organization (WTO)-compliant. Except for cases in which developing countries are involved in customs unions among themselves (i.e. in groups of countries that have agreed to levy a common external tariff), there is no technical reason for EPAs not to be negotiated on an individual country basis. Nevertheless, a key part of the EU strategy was to encourage developing countries to negotiate and reach agreements in regional groupings. The professed goal of the EU in doing this was to encourage regional integration among partner countries. As the SACU/SADC case shows, it has not been particularly successful in this regard.

For SACU, the situation was complicated by several factors.

- South Africa had already negotiated and entered into a reciprocal trading arrangement with the EU under the Trade and Development Cooperation Agreement (TDCA). Since South Africa is part of SACU, this a) makes other SACU members *de facto* partners in the TDCA, at least from the perspective of tariff treatment of imports from the EU, and b) requires agreement on any amendments to the common import tariff, including those on EU goods, in order to maintain the integrity of the customs union and avoid the need for internal SACU customs barriers.
- All SACU members are also members of SADC, and hence they were under some pressure to liaise with SADC members in their EPA negotiations.

In the end SACU became part of a negotiating group that included its own members and only two other SADC countries, Angola and Mozambique.

The negotiations were complicated by the eligibility of some members of this group to other EU trade privileges arising from their least developed country status, and by the fear of several of them of the loss of trade preferences on major export commodities in the event of failure to reach an agreement. In the case of Swaziland, preferential access for sugar was a key issue. Failure to conclude an EPA would mean the loss of Swaziland's preferential access to the EU market.

Because of its existing TDCA, South Africa did not face such pressures. However, South Africa did attempt to use the EPA negotiations to negotiate better EU market access for some products than it had previously agreed to under the TDCA. Initially the EU was not willing to entertain any such proposals, however, during the course of 2009 the EU appears to have adopted a more flexible approach.

The current problem stems from agreement by several members of the group (Botswana, Lesotho, Swaziland and Mozambique (BLSM)) to a number of "concessions" to the EU with which South Africa, and to a lesser extent Angola and Namibia, were not comfortable. The "concessions" relate to the reduction in policy space resulting from, amongst others, commitments on MFN, infant industry concerns and export taxes.

South Africa (or at least some constituencies in South Africa) has been tempted to draw from this the much more general conclusion that the BLSM countries place greater priority on access to the EU than to achieving regional integration. The latter claim seems a bit disingenuous coming from a country that has already secured its own preferential access to EU markets, and if it had to choose, surely would choose that over greater access to the tiny markets of its SACU neighbors and Mozambique.

But more importantly it presents a false choice. Regional integration in southern Africa and negotiation of freer trade with other parts of the world are not mutually exclusive strategies, but are two of many possible instruments, including unilateral tariff reform, for achieving economic development through greater and more effective integration with world markets.

Nevertheless, the differences that have emerged among members of this SADC group resulted in what is seen by some as a challenge to southern Africa integration and an agreement that will limit the region's development "policy space," and possibly undermine SADC and SACU.

What precisely are the differences that brought SACU to this impasse?
There appear to be three main areas of dispute:

- the range of tariff "concessions" requested by the EU;
- the EU's insistence on an "MFN clause" that would automatically grant to the EU any tariff preferences agreed to by "SADC group" members in future trade agreements with other parties; and,
- the request by the EU for a commitment to engage in processes leading to an examination of future liberalization of trade in services.

In each of these cases, it was South Africa that objected most strenuously to the EU liberalization proposals. In the case of tariffs, yielding to the EU requests would require further opening of the SA market to around 400 to 450 products from the EU, beyond the commitments agreed to in the EU-SA

TDCA. South African negotiators claimed that certain domestic business and labor stakeholders would be unwilling to accept such an outcome. We are not aware of any analysis of the likely economic impacts of any of these “concessions.” There are over 6,600 tariff lines covered by the TDCA. What are the 400-450 lines that would need tariff reductions? How much trade is there in these lines? And how significant is domestic production? What are the current tariff rates? Who would gain and who would lose from preferential reductions to the EU?

The South African approach to the EPA discussions reflects the cautious approach to further trade liberalization that has characterized the dti’s trade negotiating “strategy” ever since the initial (and highly successful) set of trade reforms in the early to mid-1990s. This approach identifies the national interest very narrowly as the special interests that are protected by any particular tariff, without consideration of the negative impacts on downstream users and consumers, or of the long damaging effects on competitiveness and growth. This mercantilist approach to trade reform fails to recognize the broad economic benefits of trade reform or to see and use trade negotiations as an opportunity to overcome narrow domestic interests trying to block trade reform. It certainly does not reflect the long-term interests of a country such as Swaziland. Neither does it reflect the approach of those sections of the South African private sector who wish to negotiate on trade in services.

There is a slightly more generous interpretation of the South African strategy in the EPA negotiations – South Africa, which already had well-established preferential access to the EU market under the TDCA, has tried to use the negotiations to try to broaden this access. Its refusal to agree to EU requests for additional preferences on the 400-450 items in question can then be seen as a bargaining strategy to gain additional concessions from the EU. The EU certainly can be faulted for its stubbornness in considering such South African requests. Recently there are signs that the EU may be prepared to adopt a more open approach. However, while South Africa had very little to lose in refusing to agree to EU requests, failure to reach an agreement would have much more harmful to the other members of the group who were about to lose their Cotonou preferences.

The story is similar on the other two divisive issues. South Africa has been quite adamant in objecting to both the proposed MFN clause, and the idea of pursuing any liberalization of trade in services with the EU. Were South Africa to consider the EPA negotiations as a tool for pursuing a more general trade reform agenda, she would see the MFN clause as conferring at least two benefits. First, it would ensure that any bilateral or other trade reforms would automatically apply to trade with the EU, and hence widen the benefits of any future reforms. And second, application of the MFN clause would reduce the scope for any damaging trade diversion that might result from future preferential trade agreements. The benefits of the MFN clause would be even greater for Swaziland and the other smaller members of SACU.

Similarly all the countries in SACU stand to benefit from future services liberalization. For a small, landlocked country such as Swaziland efficient transport, telecoms and financial services sectors are essential to effective participation in the global economy. And this, in turn, is essential for attracting growth and welfare-enhancing development. Any broadening of access for international service providers, together, of course, with a competition-friendly regulatory environment, can only assist in promoting Swaziland's development.

While none of these issues is likely on its own to have an enormous economic impact, they have revealed some potentially disturbing intra-SACU and SADC policy divergences. On the South African side, the willingness of Swaziland and its other "SADC group" members to initial an EPA over South African objections raised serious questions in some quarters about the value of South Africa's continued participation in SACU. This is particularly unfortunate when it is not even clear that the South African negotiators' stance on the issues reflected the country's long-term development interests.

Recently there has been progress on resolving the EPA negotiating differences, with the EU indicating some willingness to consider some of the South African negotiating demands, and the other "SADC group" members expressing a willingness to support South Africa in its position on the issues. However, the EPA negotiations have aggravated rather than helped to resolve the key issue about the direction of trade policy in SACU.

Implications of the 2002 SACU Agreement

While the EPA negotiation process has created considerable animosity and revealed some potentially important policy differences, the most urgent problems at the moment relate to two key features of the 2002 SACU agreement, namely:

- The provisions for joint decision making and consultations on both tariff policy and excise taxes, and especially
- The new revenue sharing arrangement for allocating the total customs and excise taxes collected within the union.

These issues are important both in their own right and in terms of the light they shed on some more general problems with SACU as a means of promoting regional integration and the global competitiveness of its members. There have been serious delays in implementing the new coordination mechanisms for tariff policy. The joint decision-making bodies for tariffs are not yet in place, leaving a potential legal policy vacuum. In the interim South Africa's ITAC continues (as before the Agreement) to issue decisions on tariffs, dumping and other trade remedies, etc. and some members have implemented special tariff measures and other import restrictions at the request of particular local interests to protect and promote selected "infant industries." For example, South Africa recently announced a long-term trajectory of tariffs for its motor industry, including a commitment to retain tariffs on automobiles and components (CKD kits) at 25 and 20 percent respectively until at least 2020. This was done without any consultation with its SACU partners. Decisions on whether and/or how to extend trade policy support for the textile and garment industry, primarily through the DCC system of export support have been delayed repeatedly, creating considerable uncertainty for an industry that is quite important, in terms of exports and employment, for Swaziland and Lesotho.

Quite apart from its substantive economic impacts, the legal status of this ‘interim agreement’ (or lack of agreement on new procedures) remains unclear. Given the passage of time—more than six years—there is need to come to agreement on a clear road map.

For countries like Swaziland this raises two important issues.

The first relates to Swaziland’s capacity to, and indeed interest in getting involved in detailed analysis and decision making on tariff issues on a line-by-line basis. Given her very small size, Swaziland has limited public sector capacity to deal with strategic trade and industrial development issues and so it almost certainly would be a waste of any such technical capacity to get sucked into day-to-day and month-to-month tariff decisions.

What is of much greater importance for Swaziland, and this bring us to the second key issue, is agreement on a long run trade policy strategy that is supportive of her development goals. The current SACU tariff represents in large part an outcome of interest group politics in South Africa, whereby particular sector interests have managed to capture and delay the trade policy reform process that began in the early to mid 1990s. The result is a tariff structure that obstructs rather than promotes trade, harms Swaziland’s consumers and industrial users of imported products, and thereby impedes Swaziland’s ability to integrate effectively into global production networks. Swaziland’s long-term development interest would be served best by a low and simple SACU tariff.

There is also a growing recognition in South Africa that the current tariff structure does not serve her long-term development interest, and that simplification of the tariff, primarily through reductions in all high rates to a maximum of, say, 10 percent would yield significant economic gains for the country. Whether there will be sufficient political momentum to move South Africa in this direction in the near future is open to question. But there can be little doubt that it is in Swaziland’s interest as a SACU member to push for such reforms, rather than wasting political capital and public sector expertise on monitoring the day-to-day minutiae of small adjustments to the current tariff, many of which reduce than improve its functionality as a tool for promoting domestic and regional development.

Unfortunately the current SACU revenue sharing formula creates some perverse incentives for Swaziland and the other BLNS in approaching tariff reform. The problem is that the formula distributes a highly disproportionate share of SACU customs tariff collections to the BLNS, and has made them heavily dependent on them as a source of public sector revenues. Consequently while the SACU tariff is highly detrimental to Swaziland’s (and other BLNS members’) development interests, it has become a public sector fiscal crutch.

The revenue sharing formula agreed in 2002 dealt with the allocation of common excise tax and customs duty revenues among SACU members. Table 1 shows the distribution of these revenues under the formula in 2006, together with some indicators of their importance in each SACU member state. Swaziland, Lesotho and Namibia are dependent on SACU for a very high proportion of total government revenue; Botswana is less so, primarily as a result of diamond revenues. The customs component is by far the largest share of the SACU payment; tariff revenues are far more important than excises for the BLNS. The so-called "development" component of the excise pool is also much less important than tariff revenues for the smaller member countries. It is the customs pool that has by far the largest redistributive impact—from South Africa to the smaller members. The customs revenue provisions have been the main source of concern in implementing the agreement and are certainly the biggest issue facing Swaziland at this time.

Table 1 – Receipts from SACU Revenue Pool, 2006

	Excise R million	Development	Customs	Total	Total % of GDP	Total % Gov Rev	Total per Capita
Botswana	586	483	4565	5634	9.0	20.1	3,692
Lesotho	85	560	2191	2836	28.2	53.0	1,398
Namibia	357	523	4584	5463	12.2	41.0	2,695
Swaziland	152	534	3023	3708	24.1	56.9	4,256
S. Africa	13512	493	3620	17625	1.0	3.9	666

Source: Flatters and Stern 2006

The operation of the revenue sharing arrangement is outlined below.

Excises: Most of the excise pool is distributed according to members' GDPs and is thus distributed in a neutral manner. A small share (15 percent at present) is reserved as a "development component." The development component is designed to account for differences in per capita income, but these differences are deflated by an adjustment factor that ensures that each country receives near equal shares (20 percent). Despite this adjustment, the development component does have a very strong redistributive impact (on a per capita basis) in that it reallocates revenues from the one large member (i.e. South Africa) to smaller and generally poorer ones (the BLNS).

Tariff Revenues: SACU tariff revenues are distributed according to members' shares of intra-SACU trade. This is unusual and certainly differs from the standard practice of distributing according to duty collections on each country's dutiable imports—i.e. according to their contributions to the revenue pool. Since the much smaller BLNS members have higher propensities to import, especially from South Africa, the main impact of the formula is to redistribute tariff revenues from South Africa to the smaller members. As can be seen, the redistributive impact—from South Africa to the BLNS—is enormous, and far exceeds the so-called development component of the excise pool.

The most common argument in support of this arrangement is that it compensates the BLNS for the "cost raising impact" of a tariff that has been designed primarily for the protection of industries in South Africa. Flatters and Stern (2006) demonstrate that the current allocation of tariff revenues far exceeds any amount that could be justified on such grounds.

In fact, the main reason for the adoption of this rule is that it fortuitously provided the BLNS with basically the same implicit revenue transfers that they were receiving under the old agreement. Its main benefit for South Africa was that it put a cap on the amount of transfers required under the agreement. In particular it ruled out the possibility that South Africa would be required to transfer more revenue than was generated by the SACU tariff—a real and growing possibility under the old agreement. After years of apparently fruitless negotiations over the formula, the negotiators had hit upon a proposal that appeared to "work," albeit in a very limited sense. It had no empirically or theoretically based economic rationale; but it made it possible to reach an agreement. After years of negotiations this simple fact dominated all other considerations.

The other expectation was that, whatever might be the shortcomings of the formula, especially with regard to its treatment of tariff revenues, this part of the revenue pool would gradually decrease in importance as further SACU tariff reform and negotiation of new multilateral and preferential trade agreements reduced the importance of tariffs as a source of government revenue.

Until very recently this expectation turned out to be incorrect. Contrary to expectations, there has been virtually no substantive progress in SACU tariff reform. At the same time, a boom in SACU imports of a few highly taxed consumer items, primarily automobiles, have caused an explosion in SACU tariff revenues and large revenue windfalls for the BLNS. This is shown below in Table 2 SACU revenue pool receipts by the BLNS, which were virtually constant in the years prior to the new agreement, grew by more than three and a half times between 2002 and 2008—from R8.3 million in 2002 to R28.9 million in 2008.

Table 2: SACU Payments to the BLNS (R millions)

Fiscal Year	Revenue Pool Receipts by BLNS
2000	8,395
2001	8,204
2002	8,260
2003	9,724
2004	13,328
2005	14,145
2006	25,194
2007	24,712
2008	28,920
2009	27,915

Source: SA government statistics

While there can be no question that this revenue windfall was beneficial to Swaziland and the other BLNS countries, it was not an entirely unmixed blessing.

First, the revenues have been **unstable and unpredictable**. The payments in any year have been based on SARS forecasts of excise and customs tariff revenues for the year in question. In several recent years, the forecasts have missed the mark considerably. Until now the errors have always been in the form of underestimates. Adjustments are incorporated into payments in the year following finalization of the relevant data on tax collections, trade flows, etc. This means that an underpayment in, say, 2006 results in an increase in payments made in 2008, with the adjustment payments added to the quarterly payments estimated to be due in that year. This makes fiscal planning for Swaziland and the other BLNS countries very difficult.

Second, it has created an unfortunate and highly unproductive conflict for Swaziland and the other BLNS countries in thinking about trade policy strategies. As observed earlier, it is in Swaziland's interest as a small, landlocked economy to minimize barriers to trade with the rest of world. Among other things this calls for a low and simple structure of SACU import tariffs. The current SACU tariff is far from meeting this ideal. Under the SACU revenue-sharing formula, however, in which Swaziland and the other BLNS countries share disproportionately in its revenues, significant reductions in the SACU tariff could have serious adverse fiscal consequences. Indeed, the current revenue-sharing formula dominates almost any other economic interest Swaziland might have in SACU, and in particular it gives her very little incentive to work towards a tariff and broader trade policy strategy that otherwise would far better serve her long-term development interest.

Third, the large windfalls have accrued in recent years have made Swaziland unusually dependent on and complacent about a single revenue source over which it has little control and is not dependable in the longer run. It is difficult to maintain fiscal discipline when an outside source of revenue appears to grow without restraint, and with no fiscal effort on the part of the government. After several years of runaway growth of these revenues, warnings about their eventual demise begin to lose their credibility or effectiveness. There is a growing tendency for the government to lock itself into high levels of recurrent expenditures with insufficient regard for their longer-term economic benefits or financing.

Thus, while the revenue sharing arrangement undoubtedly has brought significant short-term fiscal benefits to Swaziland and the other BLNS SACU members, there also have been some significant economic costs. The global economic downturn that has now begun to affect South Africa and its neighbors is about to put an end to the revenue glut arising from the SACU revenue sharing arrangement. As can be seen in Table 2 above, SACU payments to the BLNS grew by 17 percent in 2008 (from R24.7 billion to R28.9 billion). This was based on revenue forecasts made in late 2007. According to the most recent South African revenue data, however, customs duty collections have suffered a major collapse relative to the forecasts in the 2008 government budget. The original budget forecast was for customs duty collections of R31 billion. Based on data until the end of February this year, however, actual collections for the fiscal year are now expected to be R23.1 billion, a decrease of 25 percent from the original forecast.

For 2009, South Africa has forecast customs duty collections of R25.3 billion, an increase of about 10 percent over actual 2008 collections (and significantly less than last year's projection of R31 billion). On the basis of an even more optimistic forecast in late 2007, total SACU revenue payments to the BLNS will be R27.9 billion, or about R1 billion less than in 2008/9, a decrease of 3.5 percent. This might seem like a rather conservative forecast; and while it marks a change from the windfalls of the previous few years, it is something that should be able to be adjusted to without excessive pain.

Unfortunately this is not likely to be the case.

First, the revenue forecasts for 2009, like those for 2008, are likely to turn out to be optimistic. South Africa's imports are continuing to shrink, and this is particularly true of motor vehicles, the imports that have accounted for by far the largest share of the import duty revenue increases in recent years. Furthermore, the peculiar nature of the MIDP is likely to mean that import duty collections on motor vehicles will fall, at least temporarily, more than proportionately to the decrease in vehicle imports. This is because of the huge stock of IRCCs that are now in the hands of the major vehicle producers as a result of the rapid growth of vehicle exports in 2008. Together with the rapid decline in vehicle imports, this means that a much higher proportion of vehicle imports than usual will be imported free of import duty. This will aggravate the effects of the recession-induced decline in imports on import duty collections in the coming months.

Second, the adjustments to SACU revenue payments arising from the overestimates of the size of the revenue pool in 2008 (and most likely again in 2009) will not begin to be borne by Swaziland and the other BLNS countries until 2010 and 2011. In other words, the slight decrease in SACU revenue payments that is forecast for 2009 is just the tip of the iceberg. Almost regardless of what happens to actual SACU import duty and excise tax collections over the next couple of years, Swaziland is going to face a serious downward revenue adjustment as result of revenue overestimates last year and this year. The "gradual reduction" in SACU revenue payments that has been threatened but has not materialized since the launch of the new revenue sharing formula is finally about to hit.

IMPLICATIONS FOR SWAZILAND'S TRADE POLICY

SACU is not working as it should or as it could. Failure to fix some its biggest problems, and to do so quickly, could have serious negative economic impacts on Swaziland and the other smaller SACU members. Recognition of the seriousness of the current crisis, however, might galvanize SACU members to deal with these problems much more constructively, in a way that was not possible during the previous round of SACU negotiations. South Africa's previous concerns about the unexpected magnitude of the SACU revenue transfers, for instance, and their growing recognition of the possible destabilizing effects of the rapid decline that is now about to set in, might make her much more open to a wide range of possibilities for reform. Current discussions of the creation of a SADC customs union and/or of expanding

SACU to take on other neighboring countries make it a matter of urgent importance to turn the revenue sharing model into something that is suitable to an expanded grouping. For this to work it will be necessary to separate the sharing of common customs, excise and other revenues from redistribution and/or development initiatives based on long-term understandings and relationships among the current SACU members.

Revenue Sharing

The current revenue sharing arrangement must be divided into two quite distinct components. The first is simply a technical division of common customs tariff collections, and possibly also excises and/or VAT collections roughly in accordance with what each member would have collected on its own on the relevant transactions. This might be referred to as “pure revenue-sharing.” The second component would be an explicit redistributive or development program designed specifically to address the income and development needs of SACU’s poorer members. This is discussed separately in the following section

In the case of customs tariffs, for instance, pure revenue sharing would require some indicators of each member’s imports of taxable goods from the rest of the world.

South Africa pivotal entrepôt role in the region makes it virtually impossible to make an accurate determination of these trade flows. Any attempt to do so would require extensive border controls, transaction monitoring, and the use of burdensome rules of origin to determine the rest-of-the-world import content of intra-SACU trade flows. Even with the best of efforts, any trade flow estimates would be very rough approximations at best. The costs imposed on intra-SACU trade would defeat one of the main purposes of the customs union, and one of its main functions for a country like Swaziland, which is to improve the efficiency and development effectiveness of its integration with world markets. The difficulties and costs of trying to make accurate determinations of such trade flows have been well illustrated by application of the current revenue sharing formula that bases customs revenue shares on shares of intra-SACU trade.

An accurate measure of trade flows that could be used as a basis for customs tariff revenue allocations would be very costly to implement as it would increase trade costs, furthermore it would almost certainly not be effective. An alternative approach is to identify an indicator that is easy to measure, relatively stable on a year-to-year basis, and unlikely to generate significant controversy in its implementation. The two most obvious alternatives are population and some measure of aggregate national income. The former is certainly the simplest, and has the added advantage from the perspective of Swaziland and the other poorest (on a per capita income basis) members that it would be mildly redistributive from richer to poorer members.

Other common taxes should be shared in a similar way.

This approach to pure revenue sharing would have a number of important implications. Among the most important are:

- It would eliminate the need for and the real economic costs and controversies arising from monitoring intra-SACU trade flows and their origins. This would be beneficial to all SACU members.
- The vast bulk of the shared revenues would accrue to South Africa, since that is where most of the activity that generates the revenues takes place.

While the latter of these impacts would imply, at least in the first instance, a drastic reduction in SACU revenue transfers to Swaziland and the other BLNS members, it would also have some positive implications for them. Most importantly, the revenue costs of major duty rebate programs in South Africa, such as the MIDP, would be borne by South Africa and not the BLNS. The same would be true of duty rebate programs used by the BLNS members. Of course, the revenues collected under the high tariffs used to protect such industries would also accrue mostly to South Africa.

Redistribution and Development

The reduction in BLNS revenues arising from the "pure revenue-sharing" component will create the space for a truly redistributive and/or developmental program to assist the poorer SACU members in a manner that is no longer dependent on the vagaries of Customs duty collections, that no longer operates simply through expanding government budgets in the BLNS countries, that provides an opportunity to deal with developmental needs in a more creative and pro-active way, and that no longer creates a perverse dependence on trade and Customs tariff policies that are inherently inimical to Swaziland's effective integration into global markets and meeting her long-term development needs.

The design and implementation of a new SACU-wide redistribution and development program would present some serious challenges. It might be desirable in principle to set up a SACU Development Board and corresponding Development Fund for this purpose. This would ensure joint decision-making and a union-wide approach to securing contributions to the fund. While South Africa would be expected to be the major contributor at least for the foreseeable future, a SACU-wide approach would allow for the possibility that one or more of the wealthier and more successful BLNS members might also become net contributors.

However, experience with what should have been a much easier task of setting up a SACU Tariff Board casts serious doubt on the likely success of such a coordinated approach. Furthermore, as undoubtedly the largest contributor to any SACU development program, South Africa might have some reluctance to hand authority to an untested body over which it has limited powers.

In the short run at least, therefore, it might be better to negotiate an arrangement whereby South Africa makes a serious long-term commitment to a program of budgetary and more general development assistance to its BLNS neighbors.

Realistically, South Africa will demand and the BLNS will need to expect and accept a certain degree of conditionality in any development expenditures, in the sense that at least some of the assistance would be for well-defined projects and/or purposes. A critical question on all sides will be how to ensure proper consultation and participation in decision-making on the part of all stakeholders.

Consideration could be given to requesting the advice of a neutral international institution – IMF, World Bank – to advise on design options for such a budget and development assistance facility.

The SACU Tariff

The current SACU tariff does not serve the development interests of Swaziland or the other BLNS members. It reflects a combination of the remnants of highly protective import substitution regime from South Africa's apartheid era, the successful outcome of pressure from powerful South African lobbying groups, and an incomplete understanding in some policy circles of the role of trade in long-term economic development.

The SACU Tariff Board that was a key part of the 2002 Agreement is still not operational. If and when it does become operational, it is most likely that it will deal primarily with *ad hoc* requests, mostly from South African producers, for special rebates and other minor tariff changes, as is done by South Africa's ITAC at the moment.

Swaziland and the other BLNS countries have neither the capacity nor the economic interest in dealing with such minutiae of the SACU tariff. Swaziland's main interest should be in achieving a major simplification and reform of the SACU tariff so that it better reflects its own long-term development interests. This would require a continuation and completion of the tariff reforms begun by South Africa in the 1990s, with the ultimate goal of eliminating all tariff peaks and implementing a much more uniform and lower tariff than is now in effect. Among the most important immediate tariff reductions would be on garments, textiles and automobiles. A uniform tariff of somewhere between 5 and 10 percent on all imports, together with an effective and efficient rebate and/or exemption system for exporters would be an ideal. It would provide reasonable and uniform protection to all SACU producers, would minimize the penalization of exporters that arises from any system of import protection, and would raise a significant amount of revenue at an acceptable cost.

This would meet opposition, of course, from the vested interests in South Africa that benefit from the shelter provided by high import tariffs. However, there is growing recognition in the broader South African policy and business communities that this system does not reflect or promote South Africa's long-term development interest. The old argument that the revenue sharing formula and other redistributive mechanisms are required to compensate the BLNS for tariff policies pursued by South Africa in its own economic interest is flawed because

- Compensation under the current formula far exceeds any possible estimates of the cost to the BLNS, and
- The policies for which such compensation is provided are also not in South Africa's economic interest.

SACU tariff reform might also meet opposition from certain BLNS countries that insist on the need for "policy space" to protect "infant industries" as a means of promoting economic development. Local, regional and international experience make it very clear that such policies are prone to capture by special interests hoping to gain from local monopolies, and that a development strategy based on creating artificial "competitiveness" in the tiny markets of the BLNS countries, or even all of SACU or SADC, which is smaller in economic size than Turkey, is costly and ineffective.

A serious commitment to further major tariff reform should be part any new SACU agreement. While there are some parties, especially in SACU trade and industry departments, which will object to this, there are others that would be very receptive, e.g. SA National Treasury. If an immediate start to tariff reform cannot be achieved, Swaziland should insist at least on commissioning of a major, independent SACU-wide tariff review.

This is something that should be monitored by Swaziland on a regular basis. But beyond that, Swaziland might want to review the value of deploying scarce policy resources in a tariff board mechanism that deals primarily with issues of very little direct interest to the country.

Trade Facilitation, Non-Tariff Issues and the Investment Environment

As SACU members strive to participate more effectively in global markets, it has become increasingly clear that SACU has not delivered some of the basic functions of a customs union—most importantly in ensuring the relatively costless and frictionless movement of goods and services within the union.

Distrust of customs enforcement abilities and diligence among member states, lack of effective coordination of commodity taxes, and the desire by individual members to enforce highly restrictive trading rules on some key products have all contributed to the erection and perpetuation of costly barriers to intra-SACU trade, with serious adverse consequences for the competitiveness of nascent and long-established industries in SACU. This has serious consequences not only for the development of trading relationships within the region, but much more importantly, for the ability of the region to integrate successfully with and develop long run competitiveness in the global economy.

Of most immediate concern to Swaziland in recent years have been serious impediments to transshipment of sealed containers of export garments from Swazi factories destined for loading in Durban for shipment to the USA.

Among these impediments have been punitive VAT bonds and arbitrary customs inspections apparently based on a South African fear of smuggling of Chinese products circumventing quota restrictions imposed to protect selected South African firms. Quite apart from their highly questionable value in protecting South African firms and workers and the costs they have imposed on all SACU consumers, these policies have imposed real economic costs on garment exporters in several BLNS countries. The BLNS were not consulted in any way on the design or implementation of these policies.

CONCLUSION

SACU is facing some serious issues arising from external trade negotiations and weaknesses in the 2002 SACU Agreement. While this presents major challenges it also represents an opportunity. Can the current crisis be used as an occasion to deal not only with the particular issues arising from the 2002 Agreement, but also with more general competitiveness problems in the region? SACU might gain considerably by shifting its focus from tariff-related issues, to a more careful examination of the host of other weaknesses in the overall business and investment environment in the region. Focusing on addressing trade facilitation issues and developing a harmonized approach to addressing non tariff measures have the potential to realize significant benefits for all members. The current debates over the future role for SACU create an opportunity for it to become a more economically efficient customs union that will contribute towards increased growth and integration through reduced trade costs. Should SACU pursue this approach it has the potential to act as a model for increasing regional integration in the broader SADC and tripartite process within Africa.

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