



Evaluation of an Appropriate Model for a SADC Customs Union

DRAFT FINAL

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EXECUTIVE SUMMARY

1. Introduction

Different regions have pursued different approaches to deeper regional integration with varying degrees of success. This gives SADC an invaluable opportunity to review the performance and modalities of other regional initiatives and develop an approach that is appropriate, feasible and beneficial for all of Southern Africa. The main purpose of this research study is to describe and evaluate the alternative options for a SADC Customs Union (CU) and assess the economic impact.

This report deals with the options and modalities for a Customs Union, focusing on the experience of other regions and the realities of SADC. It reviews the current state of trade and economic development in SADC; describes the main types of Customs Union and the experience of select regional integration initiatives; considers the options for collecting and sharing revenues; evaluates the fiscal impact of a common external tariff; and analyses the economic impact of a SADC CU.

2. Trade and economic development in SADC

SADC is notable as much for the differences between countries as for the similarities. The membership ranges from poor low-income countries to upper middle-income countries. Wide differences in economic and population size are also evident. Some are landlocked and others are island states. Such vast differences in economic development, size and geography are unusual by comparison to other CUs we have studied and so pose challenges to the formation of a CU where harmonization of some policies and the implementation of a common external tariff are required.

There are also large differences in trade, and in particular, levels of intra-regional trade. SADC countries divide themselves roughly into two groups. The BLNS, Malawi, Mozambique, Zambia, and Zimbabwe depend heavily upon SADC, particularly for imports. The remaining countries maintain much stronger trade relationships with the rest of the world (ROW). South Africa is by far the largest supplier of exports to and demander of imports from the region, accounting for between 71 and 78 percent of total intra-SADC exports.

A standard “rule of thumb” is that regional integration is likely to be welfare enhancing the higher the percentage of trade with potential partners. Intra-SADC trade has grown significantly from the early 1980s. The value of intra-SADC trade as a share of total imports grew from 1.6 percent in 1980 to 10.6 percent in 2003. Similarly, the share of intra-SADC exports as a share of total exports grew from 0.9 percent to 10.6 percent over the same period. But most of this is bilateral trade flows with South Africa. Trade flows between SADC members outside of SACU is very low.

2.1. Industrial structure and trade potential

A common indicator of the potential for trade creation and diversion is the similarity in structure of production across the partners. SADC economies show enormous variation in the sectoral structures of their economies and there is unlikely to be much dislocation of industry from one member country to another. This reduces the potential gains from trade from the formation of a customs union, but also lowers the potential, short-term adjustment cost within specific industrial sectors within specific member countries.

The potential for substantial increases in trade flows within the region appears to be small and largely restricted to agriculture. Intra-SADC exports by SADC members (excluding SACU) are highly concentrated in a few products and do not match current imports by the region. South Africa is an exception to this. It dominates the region in terms of its economic size and manufacturing base and exports a diverse range of products to SADC countries, many of which are currently imported from the rest of the world.

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Existing patterns suggest as well that there is little scope for gains in intra-industry trade. Manufacturing accounts for a small proportion of overall production in most SADC economies and is highly concentrated in a few sectors. Barring major changes in economic structure the gains from trade will be largely of the inter-industry type, although there may be opportunities for specialisation in processes along the production chain (vertical integration).

Enhancing intra-regional trade alone is therefore a weak basis for the formation of the CU. The motivation for a CU will need to be driven by other factors such as the building of better institutions to facilitate growth (deeper integration issues) as well as using the CU as a vehicle towards facilitating greater openness to and competitiveness in the global economy. There is added imperative to the latter, as the retention of high MFN tariffs may lead to trade diversion, particularly in relation to South Africa.

2.2. Tariffs and other barriers to trade

Average levels of protection are similar across most SADC economies and range from 12 to 15 percent. Notable exceptions are Mauritius, with an average tariff of 3.1 percent and to a lesser extent Angola (7.1 percent) and SACU (8.2 percent). Average tariffs in these three countries are substantially lower than their counterparts implying that for convergence to a CET, some SADC economies will be required to make considerable changes in their external tariff rate. MFN tariff structures also vary enormously in terms of complexity and this will constrain the negotiation of a CET.

There are also substantial barriers to internal trade. The SADC FTA has not been fully implemented, restrictive rules of origin remain in place, and border and transport costs are high. Overlapping membership with other regional integration initiatives causes additional trade tensions which will be further heightened by the negotiation of Economic Partnership Agreements (EPAs) with the EU. The ability and willingness of SADC member countries to enhance trade facilitation and open the region to the rest of the world will have a strong bearing on the economic success of the CU.

3. Modalities for a customs union

3.1. Forms of economic integration

The term 'customs union' covers a range of scope and practice, with different configurations producing different results. Balassa identified five different regional *economic* integration forms. This distinction—that the point of reference is *economic* integration—is important because there are also political objectives for integration some of which overlap and reinforce the economic ones, but others of which can be achieved in quite different ways.

These forms are normally considered to represent a progression, with each being a further step on the road to economic integration than the ones that come before. But, as suggested below, this need not always be the case. The five are as follows.

- **Preferential Trade Arrangement (PTA)** which is the simplest form of economic integration; it requires only that participating countries grant each other preferential (but not necessarily free) access to each others markets.
- **Free Trade Area (FTA)** in which both tariffs and quantitative restrictions (QRs) are abolished between member countries which, nonetheless, retain their own external tariffs (on imports from outside the FTA) and so do not have harmonised trade policies.
- **Customs Union (CU)** in which members establish a *common customs area*. At a minimum this generally requires a common external tariff (CET) on imports from non-members and no import tariffs on trade among members.
- **Common Market**, which is a CU that allows the free movement of capital and labour among members and a harmonisation of trading standards and practises, together with a common trade policy towards third parties that goes beyond simply a CET.

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- **Economic Union** in which the members of a common market also harmonise their economic policies including some coordination of monetary and fiscal policies, and also transportation and competition policies.

SADC currently rests somewhere between the first and second steps in this progression. The main hurdles in getting from preferential trade to free trade within a customs union are the abolition of all internal restrictions on trade and the establishment of a common external tariff. But there are numerous other factors that need to be considered in determining the breadth and depth of the proposed customs union and in deciding how to collect and distribute common revenues.

4. Procedures and institutions

A wide range of practice exists in groups that all share the title of 'customs unions'. The report reviews key features of the evolution and current practice of five regional integration schemes that illustrate different types of membership, scope and progress. They are:

- the EU, which has gone further than any other regional integration scheme;
- the Caribbean Community (CARICOM), which contains both more and lesser developed countries, has a partly regionalised trade policy negotiation system, and shares as a common legacy not only history but also language, legal and educational systems and relatively free movement of labour;
- the East African Community (EAC), which has a limited membership and a clearly articulated plan to complete the CU within a relatively short period of time;
- the Central American Common Market (CACM), which has made substantial progress in recent years around a common, low-tariff policy and with a close eye on the need for members to have parity in access to the US market not only with each other but also with other states in the region;
- the Mercado Común del Sur (MERCOSUR), which forms a valuable contrast with CACM, modelled along structuralist lines with the intention of building a protected regional market that is sufficiently large to support the development of industrial and manufacturing capacity.

4.1. International experience

The experience of the five reviewed CUs reveals a number of important lessons for the formation of a SADC CU. These include:

- **Transition periods are long and in most instances implementation is partial.** Even the EU took eleven years from its creation in the Treaty of Rome to the completion of a CET in 1968. The experience of other regions has been equally complex and in many instances country or sector-specific exceptions remain.
- **Variation still exists on nominal and effective CETs.** The average applied tariff in most of the CUs is moderate, but in most cases, agreement has been achieved partly by allowing exemptions of various kinds from the CET. This not only complicates external trade negotiations but also increases transaction costs and reduces transparency.
- **Intra-regional trade is not always free.** Many transitional tariff and not-so-transitional NTBs remain to trade within all CUs except the EU. And the EU only removed the last physical, technical and tax-related obstacles to intra-Union trade in 1993, 36 years after it was founded.
- **The removal of physical and administrative barriers is slow.** Most CUs have undertaken major efforts to remove direct barriers to trade but progress is mixed and even in the EU full harmonisation of standards and technical regulations has not been achieved (although it goes very much further than in any of the other CUs reviewed).

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- **Most CUs have (limited) provisions on competition.** There is a strong body of thought that a major (possibly the most important) contribution to the success of the EU common market has been a strong supra-national competition policy and a set of EU-wide laws. Other CUs have some provisions on competition, but none of the others has an effective, supra-national competition authority as in the EU.
- **Formal SDT is rare.** Special attention can be given to the needs of lesser developed members of a CU through the application of provisions on exemptions from the CET, implementation periods, safeguards etc. But formal provisions to treat lesser developed members differently or provide them with special financial flows are rare. It is most apparent in CARICOM and the EU.
- **Agreement on trade in services is even rarer.** The EU, alone among the five CUs reviewed, has attempted to remove barriers to services trade – but the European services market is only very partially regionalised.

5. Options for revenue collection and distribution

5.1. Key features of other Customs Unions

A major initial question that arises in the formation of a customs union is whether the customs revenues collected are to be treated as “community property” or as income accruing to each of the member states.

If one of the main objectives of the customs union is to facilitate a coordinated reduction in internal and external trade barriers and facilitate the region’s integration into the global economy, then the formation of the union will deliberately lead to a reduction in overall reliance on customs duties as a revenue source. In that case, a significant share of revenue collections might end up being allocated to the joint administration of the customs tariff. Even if the tariff continues to be a significant revenue source, the union still might decide to treat all or part of these revenues as a pool to be used for common development purposes. The EU is the only existing Customs Union to have implemented this model.

Almost all other customs unions (seven out of the nine reviewed in this study) collect and allocate revenues according to the destination principle. This usually requires that imports remain in bond until they reach the country of ultimate consumption, where the tariff is paid and kept. In SACU, duties are supposed to be collected at destination and then shared according to a complex revenue sharing formula, but in practise, duties are collected at the point of first entry into the customs union.

In addition to and within each of these options, it is still necessary to establish common institutions to administer the union and to possibly provide financial or technical support to poorer member countries. These institutions can be funded out of common revenues (as in the EU) or out of direct contributions from member states. UEMOA/WAEMU, for example, provides for an additional tax of 1% on imports.

5.2. Revenue options for SADC

The international experience and the principles reviewed in the report lead to a limited number of options for collecting revenues and a number of alternative methods for allocating these collections to member states. The main decisions to be made by SADC are a choice between a) collection on arrival or at destination and b) with or without subsequent changes in “ownership” of the revenues. Changes in ownership can come about, in turn, through a fund (community ownership) or through a formula.

A pure destination-based allocation of the tariff revenue is unlikely to be workable within SADC given existing disparities of income and differences in economic development and geography. In practice, a few countries would collect and keep most of the customs duties on imports into the region regardless of the final destination; and these same countries would probably benefit most (or lose the least) from the effects of trade diversion. Moreover, the proper implementation of this approach would require strict bond processes and possibly even rules of origin within the customs union, thereby raising internal border frictions.

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Moving to an approach where revenues are retained at the point of first entry in the CU would greatly diminish the administrative costs associated with the destination principle and from a customs perspective, would enable the free movement of domestically produced and imported goods between member states. But this approach might have serious revenue implications for land-locked or peripheral SADC member states, several of which are highly dependent on customs duties as a source of government revenue. For this approach to work for all SADC member states, will require the development of a revenue sharing mechanism or common fund.

6. Revenue impact analysis

To evaluate the net revenue and economic effect of various options, it is necessary to calculate the customs revenue likely to be collected under different CET options. Ideally, the CET options tested in this study should replicate those proposed by the consultants working on Study No.2; but the scheduling of the two projects makes this impossible. Instead, a spectrum of hypothetical CETs have been derived and applied throughout Study No.1. These are as follows:

- A uniform tariff of 10%;
- The current SACU CET;
- The lowest MFN schedule in SADC (Mauritius); and
- The 'simplest' MFN schedule in SADC (DRC).

Nine of the 14 SADC member countries would experience significant revenue reductions if the Mauritius tariff was applied region-wide. The current SACU tariff would cause problems for 6 member countries, and at least two countries would experience large revenue adjustments under the other two options. Tanzania, Zimbabwe, Malawi, Madagascar and Lesotho appear to be particularly vulnerable to tariff revenue adjustments.

The net fiscal effect depends not only on the impact of any change in customs duties on government revenue, but the importance of government revenue (and expenditure) in total GDP and on the ability of member states to raise other taxes (or reduce unnecessary government expenditures) in response to declining tariff revenues.

In those countries where duties constitute a high share of government revenue, government itself is pretty small. The only exceptions are Zambia and the BLNS. Furthermore, almost all SADC member states could manage the revenue adjustment expected from modest tariff reform (a 10% uniform import tariff) through minor adjustments to other taxes. Lesotho, Swaziland and to a lesser extent Zambia and Namibia, are the main exceptions.

In the case of the SACU members in this group, the impact arises in large part from the redistributive impacts of the current SACU revenue sharing formula and could possibly be dealt with through intra-SACU adjustments and arrangements.

The revenue analysis has a number of implications for the design of the CET and method for collecting and distributing revenues:

- Firstly, in all CET options simulated there are winners and losers. The success of the CU will to a large extent depend on the ability to negotiate a CET and revenue sharing arrangement that is acceptable to all countries.
- Second, the SACU CET revenue sharing formula within SACU are important constraints to such an agreement.
- Third, many economies are highly dependent on customs revenue as a source of government revenue. Revenue decreases may thus pose significant economic costs on these economies and thus threaten the viability of the CU. General assistance in tax reform in affected countries might be a useful and necessary part of revenue adjustments.

7. Economic impact analysis

SADC economies are in the process of implementing a Free Trade Agreement (FTA). Under the SADC Regional Indicative Strategic Development Plan (RISDP) adopted in August 2003, SADC economies have envisaged the establishment of a Customs Union (CU) by 2010, a

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Common Market by 2015 and a Monetary Union by 2016. As indicated in the taxonomy of regional agreements presented above, a customs union implies a deeper degree of integration than a free trade area. Nevertheless, unless rules of origin serve to largely offset the tariff reductions of an FTA, many of the trade-induced adjustments to economic structure will likely be brought about through the implementation of the SADC free trade area. The likely incremental impacts of a customs union arise via:

- Changes to external tariffs of each country through application of a common external tariff (CET),
- Revenue gains/losses and revenue sharing rules,
- Gains from the elimination of rules of origin, and
- Deep integration encompassing issues such as institutions, foreign direct investment, infrastructure, and domestic regulatory impediments to trade, among others.

These likely incremental economic effects of a customs union are considered by drawing on international experience and by using a variety of empirical methods. The following principal conclusions emerge:

- The CU can be effective in promoting development and welfare gains if it is used as an instrument to promote openness and integration into the world economy. The largest economic gains arise if the customs union leads to liberalisation of the external tariffs.
- Additional welfare gains can be realised if the CU leads to lower cross-border transaction costs through improved infrastructure, border controls, harmonisation of standards, improvements in trade facilitation etc.
- The benefits of deeper integration policies also depend on the extent to which they make the region more attractive to foreign, regional and domestic investment. Stable and predictable policies and institutions are good for growth.
- While the benefits of regional trade are worth capturing and may be a very important for some SADC members, intra-regional trade is unlikely to be the main driver of regional development. Growth through this mechanism alone is likely falter as the regional market is small. A customs union provides greatest gains when it serves as a part of a generalized strategy of openness.

8. Deciding a model for a SADC Customs Union

The primary objective of this study is to recommend an 'appropriate model' for a SADC Customs Union (SADC CU). Part of this decision is economic and we can draw a number of key lessons from the economic experiences of other regional integration initiatives and from the revenue and economic impact analysis presented in the report. This analysis shows that a SADC Customs Union can generate real welfare benefits for the region.

But achieving these gains and ensuring that they accrue to all member countries, depends on a number of critical assumptions and pre-conditions:

- The challenges to forming a CU are large and will require strong political commitment to the process. Very few regional integration initiatives have progressed into a Customs Union and those that do exist have moved slowly and are not particularly deep. The sequencing and establishment of common procedures and institutions is hard but important.
- One of the most important contributions a SADC Customs Union can make to the competitiveness of regional economies would be to reduce barriers to trade with the rest of the world and this requires agreement on a low, simple and stable CET.
- Trade facilitation is a major problem in SADC. There are many ways in which trade facilitation can be enhanced within the framework of the current FTA arrangements and

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this is a current focus of SADC activity. Implementation of a CU might focus greater attention on this issue, and there is no doubt that the successful creation of a common customs area through a SADC Customs Union could make a major additional contribution.

- In most currently functioning customs unions, revenue is collected and retained at the final destination. In SADC, this would require the maintenance of costly internal border controls and from a revenue perspective, would favour the more developed SADC member states. It would be preferable to reduce such controls, collect duties on entry and then design a simple mechanism for reallocating revenues in a manner meant to approximate patterns of import consumption.
- In addition to and separate from a revenue sharing mechanism, SADC will need to consider the establishment of a general development fund to support SADC-wide development projects and assist with adjustment in particular member states.
- Overlapping membership is inconsistent with the formation of the SADC CU. Given the complexities associated with the negotiation of a CU and the political commitment necessary to do so, it is essential that SADC economies choose which CU they wish to participate in.
- South Africa, as the dominant economy within the region, plays a crucial role in the success of negotiating the CU. This will require concessions by South Africa, particularly in relation to tariff setting and revenue distribution. Simplification of the complex SACU tariff structure may be necessary to reach agreement on a SADC-wide CET.

The analysis and international experience presented in this report confirm that these seven conditions are critical to the establishment of functioning and economically-beneficial customs union in SADC. If these pre-conditions cannot be met, then the gains from regional integration will be smaller than forecast and the likelihood of forming a functioning customs union much lower. This should not prevent progress in each of these areas. It is possible to achieve many of the economic gains from lower tariffs and improved trade facilitation through a well functioning FTA and this might prove an important first step towards the establishment of an open, efficient and predictable customs union in Southern Africa.

SECTION A: INTRODUCTION

1. Background

The SADC Regional Indicative Strategic Development Plan (RISDP), adopted by Heads of State and Government in August 2003, provides for the establishment of a SADC Customs Union by 2010. This decision was reaffirmed at the October 2006 SADC Extra-Ordinary Summit, where it was also determined that a series of technical studies was required to inform the model and structure of the SADC Customs Union.

Different regions have pursued different approaches to deeper regional integration with varying degrees of success. This gives SADC an invaluable opportunity to review the performance and modalities of other regional initiatives and develop an approach that is appropriate, feasible and beneficial for all of Southern Africa.

2. Research objectives and approach

The objectives of this study are three-fold:

- To identify, describe and evaluate appropriate options and modalities for a SADC Customs Union;
- To identify, describe and evaluate possible revenue collection and sharing options and modalities for a SADC Customs Union; and
- To assess the economic effects and impact of alternative options and modalities.

To fulfill these objectives required a wide range of desk-top research; detailed trade, tariff and revenue analysis; and economic modeling. Different components were undertaken by experts in each of the study areas and the project team involved a large number of senior regional and international economists. The methodology adopted in each component is described in the text.

The resulting study provides for a comprehensive account of the experiences of customs unions elsewhere and the particular features of SADC. This analysis and information should assist SADC in understanding the challenges involved in the formation of a regional customs union and the recommendations presented in this report provide guidance on how this might be achieved in Southern Africa.

3. Data

The report uses a data from many different sources and time periods. Specific references are included in the text. Unfortunately, the urgency of this assignment did not provide for sufficient time to visit individual countries and consult with officials and experts in these countries on the accuracy and consistency of this data. For this reason, some of the data is not up to date and might not be consistent across different sections of the report. Despite these shortcomings, the economic analysis is robust and any data problems are unlikely to affect the main conclusions.

4. Structure of the report

This first report deals with the options and modalities for a Customs Union, focusing on the experience of other regions and the realities of SADC. Section B reviews the current state of trade and economic development in SADC; Section C describes the main types of Customs Union and the experience of select regional integration initiatives; Section D considers the options for collecting and sharing revenues; Section E evaluates the fiscal impact of a

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common external tariff; Section F provides the economic impact analysis; Section G outlines the policy options and 'models' available to SADC; and Section H presents the key findings and recommendations of this study.

SECTION B: TRADE AND DEVELOPMENT IN SADC

The section first draws on various economic indicators to give insight into the likely welfare effects arising from the implementation of the free trade agreement as well as the proposed customs union. In particular, the tariff structure, production and trade flows across SADC economies are analysed to identify the potential for gains from trade and specialization and to shed some light on the main opportunities and challenging that countries are likely to encounter in implementing a SADC CU. The economic information and lessons drawn from this analysis and presented at the end of this section provide important inputs in determining the likely structure and optimal model for deeper regional integration in Southern Africa.

1. Economic development and macroeconomic performance

SADC is notable as much for the differences between countries as for the similarities. The membership ranges from poor low-income countries, such as the Democratic Republic of Congo (DRC), Malawi, Mozambique and Lesotho, to upper middle-income countries such as Botswana, South Africa and Mauritius. The total area of the region is 9.8 million square kilometres, which is slightly larger than that of China or USA. DRC, Angola and SA make up close to 50 percent of the total area, while Lesotho, Mauritius and Swaziland make up less than half a percent of the area. (See Table 1) Furthermore, the size of the overall SADC market is small; even including South Africa, the total market is smaller than that of Turkey or Belgium.

Wide differences in the level of economic development and population size are also evident. The average GDP per capita in Botswana, Mauritius and South Africa (11,000 to 12,700 US\$) is roughly 16-18 times that of DRC, Malawi and Tanzania and 10-13 times that of Mozambique, Madagascar and Zambia. The varying levels of income are reflected in the differing degrees of urbanisation, with Angola, Botswana and South Africa having mostly urban populations while Lesotho and Malawi are still predominantly rural (Table 1). Aid is relatively unimportant to the SACU economies but is a significant factor for the DRC, Madagascar, Malawi and Mozambique where it ranges from 18 to 28 percent of Gross National Income.

Table 1. Vital Statistics, 2005

	Population (m)	Urban population (% of total)	Surface Area (sq km)	Aid (% of GNI)	GDP per Capita (PPP)
Angola	15.9	53.3	1,246,700	1.5	2,335
Botswana	1.8	57.4	581,730	0.7	12,387
DRC	57.5	32.1	2,344,860	26.9	714
Lesotho	1.8	18.7	30,350	3.9	3,335
Madagascar	18.6	26.8	587,040	18.7	923
Malawi	12.9	17.2	118,480	28.4	667
Mauritius	1.2	42.4	2,040	0.5	12,715
Mozambique	19.8	34.5	801,590	20.7	1,242
Namibia	2.0	35.1	824,290	2.0	7,586
SA	46.9	59.3	1,219,090	0.3	11,110
Swaziland	1.1	24.1	17,360	1.7	4,824
Tanzania	38.3	24.2	945,090	12.5	744
Zambia	11.7	35.0	752,610	13.9	1,023
Zimbabwe	13.0	35.9	390,760	11.4	2,038

Source: World Bank World Development Indicators

Notes: GNI represents Gross National Income, GDP is Gross Domestic Product and PPP is Purchasing Power Parity.

The disparity in overall economic size, as measured by GDP (US\$ m, 2000 prices) is evident in Table 2 and Figure 1 below. In 2005, South Africa contributed 69% of the region's total

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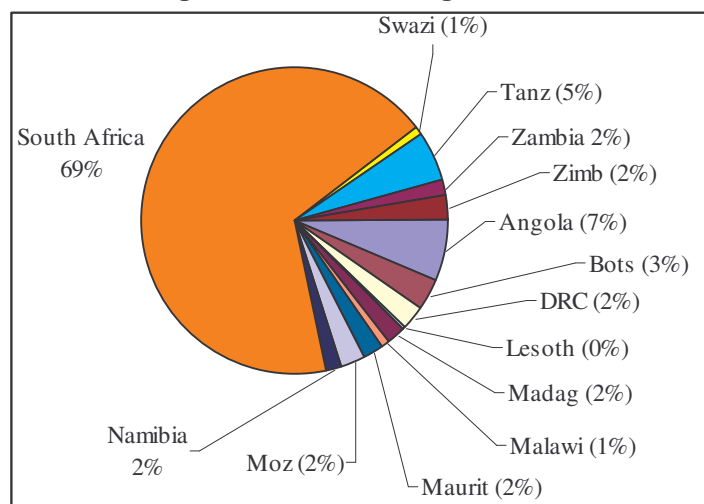
income. In contrast, the smallest economy, Lesotho, added 0.4% of the region's income and its economy was 161 times smaller than its neighbour South Africa. The closest economy to South Africa in terms of GDP is Angola, but even this economy is 11 times smaller.

Table 2. GDP and GDP Growth of the SADC Economies, 1995-2005.

	GDP (US\$ m, 2000 prices)		
	1995	2000	2005
Angola	6,699	9,129	14,935
Botswana	4,139	6,177	8,204
DRC	5,264	4,306	5,236
Lesotho	746	859	988
Madagascar	3,213	3,878	4,340
Malawi	1,439	1,744	1,986
Mauritius	3,440	4,469	5,475
Mozambique	2,579	3,778	5,773
Namibia	2,872	3,414	4,231
South Africa	115,812	132,878	159,695
Swaziland	1,180	1,389	1,548
Tanzania	7,434	9,079	12,646
Zambia	2,820	3,238	4,090
Zimbabwe	7,148	7,399	5,547

Source: World Bank World Development Indicators

Figure 1: Share total regional GDP



Source: Own calculations using World Bank World Development Indicators

Such vast differences in economic development and economic size pose challenges to the formation of a CU where harmonization of some policies and the implementation of a common external tariff is required. Differences in macroeconomic performance across regions also inhibit the negotiation of common policies. This is explicitly recognized in the SADC Regional Indicative Strategic Development Plan (RISDP) which calls for macroeconomic convergence on a number of indicators: inflation, ratio of budget deficit to GDP and nominal value of public and publicly guaranteed debt to GDP. Performance on this front is mixed:

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Inflation

Progress has been made in reducing inflation, but inflation rates still vary enormously across countries. This is shown in Table 3 where all SADC economies other than Zimbabwe, reduced inflation between 1995 and 2005. However, inflation in six of the economies (Angola, DRC, Madagascar, Malawi, Zambia and Zimbabwe) still exceeds the single digit goal for 2008, as set out in the RISDP.

Table 3. Trade and Inflation in the SADC Economies

	Trade Balance (% of GDP)			Inflation (% change in CPI)		
	1995	2000	2005	1995	2000	2005
Angola	Na	26.8	25.3	2,672.2	325.0	23.0
Botswana	12.9	18.9	16.1	10.5	8.5	8.6
DRC	4.8	1.0	-7.7	541.9	550.0	21.3
Lesotho	-98.9	-62.7	-40.1	9.3	6.1	3.4
Madagascar	-7.6	-7.3	-14.7	49.0	10.7	18.5
Malawi	-17.7	-9.7	-26.2	74.9	35.4	15.4
Mauritius	-5.5	-1.9	-4.4	6.1	5.3	4.9
Mozambique	-25.4	-21.9	-9.7	54.4	12.7	7.2
Namibia	-6.2	-5.5	1.2	10.0	9.0	2.3
South Africa	0.7	3.0	-1.5	8.7	5.4	3.4
Swaziland	-18.6	-15.6	-7.1	12.3	3.7	4.8
Tanzania	-17.9	-8.3	-9.2	24.0	6.2	8.6
Zambia	-3.7	-10.4	-8.8	34.9	26.0	18.3
Zimbabwe	-2.7	-0.3	-10.1	22.6	55.7	132.7

Source: World Bank World Development Indicators

Growth rates

There is also wide variation in growth rates across countries. Overall economic growth in SADC economies has improved from 2000, but this growth is not evenly spread across countries (Table 4). Angola, Botswana, Mozambique and Tanzania experienced 5 percent or more growth in GDP per capita per annum from 2000 to 2005. Zimbabwe, in contrast, has experienced severe negative growth during this period.

Table 4: Growth in GDP per capita (PPP, US \$, 2000 prices).

	1960-1980	1981-1990	1991-1999	2000-2005
Angola	1.7	1.5	-1.6	7.3
Botswana	3.4	6.3	2.0	5.7
DRC	0.2	-2.3	-8.8	1.1
Lesotho	1.4	2.0	3.8	2.7
Malawi	1.0	-1.2	2.4	0.4
Mauritius	0.3	5.0	4.1	3.2
Madagascar		-1.0	-0.6	-0.5
Mozambique	1.4	-1.9	3.1	6.7
Namibia	n.a	-3.3	0.7	2.9
SA	1.7	-2.1	0.4	2.4
Swaziland	3.4	3.4	0.5	0.6
Tanzania	0.7	-0.4	-0.2	4.8
Zambia	0.5	-2.7	-0.9	3.0
Zimbabwe	1.5	0.1	0.3	-6.2
Average	1.4	0.3	0.4	2.7
Standard Deviation	1.1	3.1	3.3	3.4

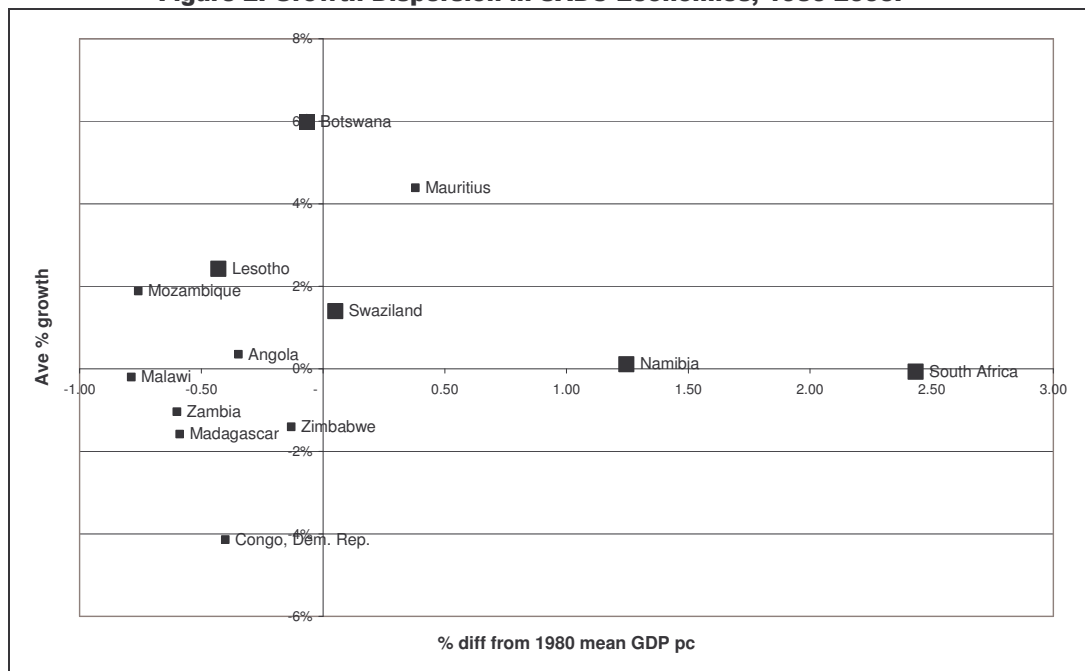
Source: World Bank World Development Indicators

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Of more importance than growth rates over short periods, is whether the economies have grown and/or converged over longer periods of time. There is considerable international evidence that more open economies grow and converge more quickly and an objective of RTAs, particularly customs unions, is to encourage this process. A major goal of regional integration in SADC is to increase both the rates of growth and the convergence of this growth among Member States.

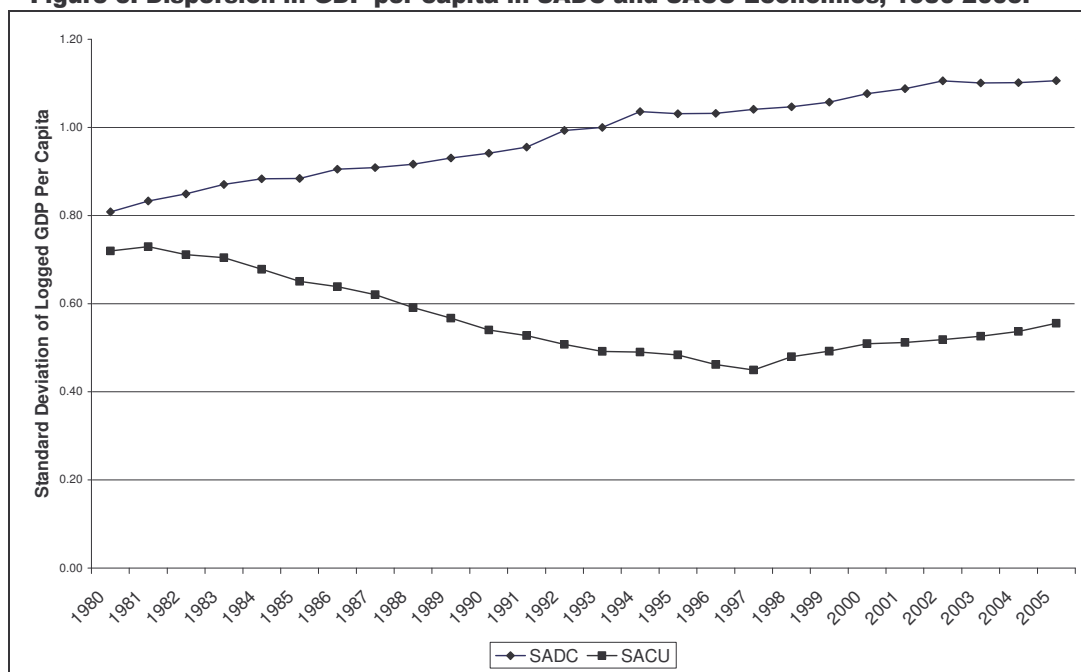
Most SADC economies have grown relatively slowly over the past quarter decade. SACU economies show strong convergence in GDP per capita between 1980 and 2005, but no such relationship is found for SADC as a whole. This can be seen in Figure 2 which plots the percentage difference from the 1980 mean GDP per capita (using purchasing power parity exchange rates) for each SADC economy against average annual GDP per capita growth between 1980 and 2005. A negative relationship is indicative of convergence, i.e. poor economies in 1980 are expected to grow faster in the subsequent period. There is no evidence of a negative relationship for the full sample of SADC economies, but reasonable convergence is found if the sample of countries is restricted to SACU. The enhanced integration afforded by a customs union may have contributed to convergence within SACU, however, this is difficult to prove.

Figure 2: Growth Dispersion in SADC Economies, 1980-2005.



Source: World Bank World Development Indicators

An alternative measure of convergence is the trend in the dispersion of logged GDP per capita over time. Declining dispersion reflects greater convergence. Figure 3 presents the trend for SADC and for SACU. The evidence shows continued dispersion of GDP per capita in SADC throughout the period. On the other hand, convergence in SACU was quite strong until 1997 when income per capita levels began to diverge. This divergence is caused in part by the strong growth of Botswana, the country with the highest income per capita in the smaller customs union, whose growth rate has been quicker than the other SACU members.

Figure 3: Dispersion in GDP per capita in SADC and SACU Economies, 1980-2005.


Source: Own calculations using World Bank World Development Indicators

2. Intra-regional trade flows

The economic effects of RTAs are influenced by the share of trade with partner countries as well as the composition of this trade. A standard rule of thumb is that RTAs are more likely to be welfare enhancing the higher the percentage of trade with potential partners (Evans et al. 2006: 87). This section therefore presents some background data on trade openness within SADC economies and the level and composition of intra-SADC trade.

SADC economies are relatively open, as measured using the ratio of exports plus imports to GDP (Table 5). Openness is particularly high in Angola, Mauritius, Lesotho, and Swaziland. The high ratio of trade to GDP arises from both exports and imports, although in most countries imports dominate, leading to trade imbalances. We also find that 8 of the economies have become more open during the period 1990 to 2005. Only Namibia, Botswana and Zambia showed considerable declines in openness during this period.

Table 5: Trade openness, (Exports + Imports)/GDP

	1990	1995	2000	2005
Angola [AGO]	59.8	-	152.5	121.8
Botswana [BWA]	104.8	89.0	86.3	85.3
Congo, Dem. Rep. [ZAR]	58.7	52.2	43.8	70.9
Lesotho [LSO]	139.3	141.5	122.2	135.9
Madagascar [MDG]	44.6	55.8	68.7	66.0
Malawi [MWI]	57.2	78.5	60.9	79.8
Mauritius [MUS]	135.6	121.7	127.3	117.4
Mozambique [MOZ]	44.2	56.6	61.3	74.9
Namibia	119.3	105.2	96.8	91.3
South Africa [ZAF]	43.0	44.9	52.8	55.7
Swaziland [SWZ]	161.7	168.1	178.7	183.7
Tanzania [TZA]	50.1	59.3	37.1	43.4
Zambia [ZMB]	72.5	75.8	52.5	41.6

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Zimbabwe [ZWE] 45.7 79.2 72.2 95.7

Source: World Bank World Development Indicators

Note: data for Madagascar were not available.

Turning to the structure of imports and exports for SADC countries presented in Table 6 and Table 7, several interesting features are evident. First, intra-SADC trade has grown significantly from the early 1980s. The value of intra-SADC trade as a share of total imports grew from 1.6 percent in 1980 to 10.6 percent in 2003. Similarly, the share of intra-SADC exports as a share of total exports grew from 0.9 percent to 10.6 percent over the same period.¹

Second, with respect to trade dependence, SADC countries divide themselves roughly into two groups. The BLNS, Malawi, Mozambique, Zambia and Zimbabwe depend heavily upon SADC, particularly for imports. These countries source about 50% or more of their imports from SADC and sell upwards of 20% of their exports to SADC. The remaining countries in SADC maintain much stronger trade relationships with the rest of the world (ROW). Mauritius, for example, sources 13.2 percent of its imports from SADC, but only sells 2.1 percent of its exports to the region. SACU, in contrast, sources only 1.9 percent of its imports from the region, although this has grown since 2000, possibly in response to the reduction in tariff barriers against SADC economies in accordance with the SADC Trade Protocol. SADC accounts for a much higher percentage (9.7%) of SACU exports leading to large trade imbalances between SACU and the rest of SADC.

Third, South Africa is by far the largest supplier of exports to and demander of imports from the region. As shown in Table 8, SACU accounts for between 71 and 78 percent of total intra-SADC exports. Only Tanzania and Zambia are less dependent on SACU (mainly South Africa) as a destination of their SADC exports. SACU members account for between 45 and 50 percent of these economies exports to SADC (Table 7). The region is even more dependent South Africa as a source of imports. 90 percent of SADC (excluding SACU countries) imports from the region are sourced from SACU (Table 6).

The implication is that although we find a relatively high proportion of SADC economies trade is conducted within the region, most of this is bilateral trade flows with South Africa. Trade flows between SADC members outside of SACU is very low (less than 10 percent of total trade), except possibly for Zambian exports.

The predominant role of South Africa in intra-regional trade is in part simply a reflection of its entrepôt role—as a logistical hub for the region's trade with the rest of the world. This helps to explain why the highest trade dependence with South Africa is displayed by countries that are logistically connected to South Africa and hence are able to take advantage of her larger market and greater connectedness with world markets. Unfortunately, the data do not permit us to distinguish between entrepôt and non- entrepôt trade with South Africa.

Table 6: Share of SADC trade in SADC country imports

	1980	1985	1990	1995	1999	2003	Proportion from SACU 2003
Angola	0	0.6	0.8	7.1	10	Na	100
DRC	0.4	1.6	1.1	18.1	31.5	Na	74
Malawi	36.7	53	24.8	49.2	64.4	57.5	65
Mauritius	14.5	4.2	9.9	11.3	11.2	13.2	97
Mozambique	3.7	5	7.6	55.5	58.6	39.5	97
SACU	0.1	1.8	1.8	2.1	1.9	2.7	
Tanzania	0.7	0.7	1.3	13.9	13.3	15.0	66

¹ SACU is treated as a single region. If SACU members are treated separately, then the share of intra-SADC trade rises in response to the very high proportion of intra-SACU trade by BLNS economies.

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Zambia	1.2	10.9	7.9	49.1	65.5	65.0	95
Zimbabwe	8.3	31.7	33.1	51.2	51.2	56.1	94
Intra-SADC Share	1.6	4.7	5.1	9.9	10.2	10.6	90 ^a

Source: Own calculation using SADC trade database (www.sadctrade.org)

Note: Data for Madagascar were not available. 2002 values used for Zimbabwe. Trade flows rose ten fold in 2003 and then reverted back to 2002 values in 2004.

a. 90 percent of SADC (excluding SACU countries) imports from the region are sourced from SACU.

Table 7: Share of SADC trade in SADC country exports

	1980	1985	1990	1995	1999	2003	Proportion to SACU 2003
Angola	0.03	0	0.01	0.03	0.7	Na	
DRC	0.05	0.03	0.1	6	0.3	Na	
Malawi	12.4	15.4	1.6	17.2	16.9	20.1	74
Mauritius	1.4	0.1	1.2	1.4	1.4	2.1	76
Mozambique	1.1	0.3	0.2	32.1	17.41	24.6	74
SACU	0.7	2.8	2.5	10.7	11.5	9.7	
Tanzania	5.2	0.1	0.5	1.4	7.4	9.4	45
Zambia	0.9	3.1	0.8	3.8	7.8	40.6	50
Zimbabwe	1.3	25	30.7	31.7	28	30.5	79
Intra-SADC	0.9	3.4	3.1	9.9	10	10.6	68 ^a

Source: Own calculation using SADC trade database (www.sadctrade.org)

Note: Data for Madagascar were not available. Zambian exports to SADC grew from 29% of total exports in 2000 to 51% in 2004. 2002 value is used for Zimbabwe.

a. 68 percent of SADC (excluding SACU countries) exports to the region are destined for SACU markets.

Table 8: Contribution of each country to intra-SADC exports

Source of intra SADC exports	1980	1985	1990	1995	1999	2003
Angola	0.2	0	0	0	0.9	Na
DRC.	0.4	0.1	0.1	2.7	0.1	Na
Malawi	11.1	6.1	0.5	1.9	2.3	1.8
Mauritius	2.2	0.1	1.4	0.6	0.6	0.7
Mozambique	1.8	0.1	0.1	1.4	0	4.7
SA	64.2	50.5	56	76.5	77.8	71.4
Tanzania	9.6	0.1	0.2	0.3	1.3	1.4
Zambia	4.4	4.1	1	1.3	2	7.0
Zimbabwe	6	38.9	40.7	15.4	14.9	13.0
Total	100	100	100	100	100	100

Source: Own calculation using SADC trade database (www.sadctrade.org)

Note: Data for Madagascar were not available.

3. Industrial structure and trade potential

A key objective for many economies in joining a CU is to enhance their own industrial development (Cooper and Massell, 1965). The ability to realise these goals depends on the country's comparative advantage and the potential to enhance the gains from trade through regional trade flows. Wide differences in comparative advantage are likely to lead to a welfare improving RTA (Evans et al., 2006: 86). At the same time, diverging production structures and trade flows may complicate the formation of a CU, particularly, where a CET will lead to substantial disruption of production or is perceived not to facilitate the industrial development of the country.

3.1. Industrial structure

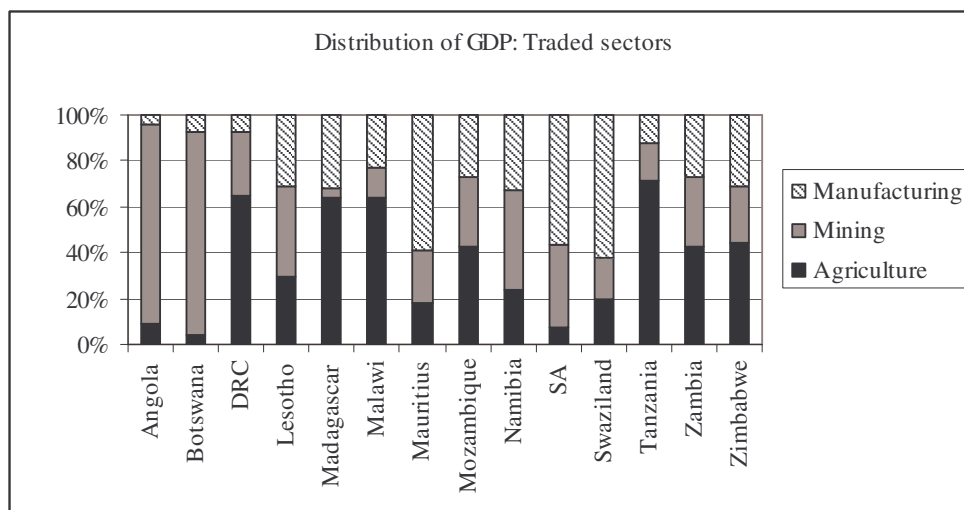
A common indicator of the potential for trade creation and diversion is the similarity in structure of production across the partners. In the standard Viner model of CU, the more similar the product mix in the partner economies, the more scope for substitution in production and the more likely there will be trade creation (Evans *et al.*, 2006: 64). Similar production structures also facilitate agreement on the common external tariff as well as regional and domestic industrial policies. SADC economies, not least South Africa, have placed a high degree of importance on the role of industrial policy in determining trade policy.

However, in highly unequal developing economies the disruptions resulting from relocation of production may be perceived as too high and inconsistent with the development goals of the economy. In these cases, complementarity, rather than competitiveness (or degree of overlap) of industrial production is most important. Larger markets provided under the RTA may enable firms to specialise according to comparative advantage or through the realisation of economies of scale without the accompanying loss of industry under a competitive scenario. There is, however, a danger of trade diversion occurring in these cases, particularly if the RTA provides preferences to relatively inefficient industries.

This reasoning needs to be adjusted, however, when the development perspective shifts from development on the basis of regional markets to development based on greater integration with and competitiveness in global markets. ASEAN, for instance, which started with much larger markets than are found in SADC, has built a free trade area and improved regional integration on the basis of development of production networks focused on global markets. A substantial part of the trade that takes place among ASEAN economies, and with the greater East Asian region, is in intermediate products whose production is parceled out among different countries, poorer and richer, according to differences in their cost structures. This has equipped the region to improve its competitiveness and export success in global markets, with resulting high growth rates for all members subscribing to this strategy.

SADC economies show enormous variation in the sectoral structures of their economies, particularly in the traded goods sectors. Figure 4 presents the distribution of manufacturing, mining and agricultural value added for the SADC economies in 2005. Many of the economies are highly dependent on mining (Angola and Botswana) and agriculture (DRC, Madagascar, Malawi, Tanzania). Manufacturing accounts for over 50 percent of value added in traded good sectors for South Africa, Mauritius and Swaziland. In both Mauritius and Swaziland these manufactures are largely concentrated in a few sectors (clothing in the case of Mauritius and sugar, syrup for soft drinks, dairy, and forestry in Swaziland).

Figure 4: Distribution of GDP: Traded Sectors, 2005



Source: World Development Indicators

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The limited overlap in production suggests that there is low potential for trade creation from the Customs Union. There is therefore unlikely to be much dislocation of industry from one member country to another. This reduces the potential gains from trade from the formation of a customs union, but also lowers the potential, short-term adjustment cost within specific industrial sectors within specific member countries. In other words, differences in industrial structure and low levels of competition within SADC may make it easier to establish a Customs Union.

3.2. Indicators of trade potential

An expected outcome of the CU is an increase in intra-regional trade flows. While existing trade flows do not predict future trade flows, they provide useful insights into the prospects for intra-regional trade. We have already seen that intra-SADC trade accounts for a high proportion of trade flows by its members, although the bulk of this reflects trade with South Africa. We now explore the composition of this trade in more detail with the objective of identifying the potential for an increase in welfare enhancing trade flows within the region.

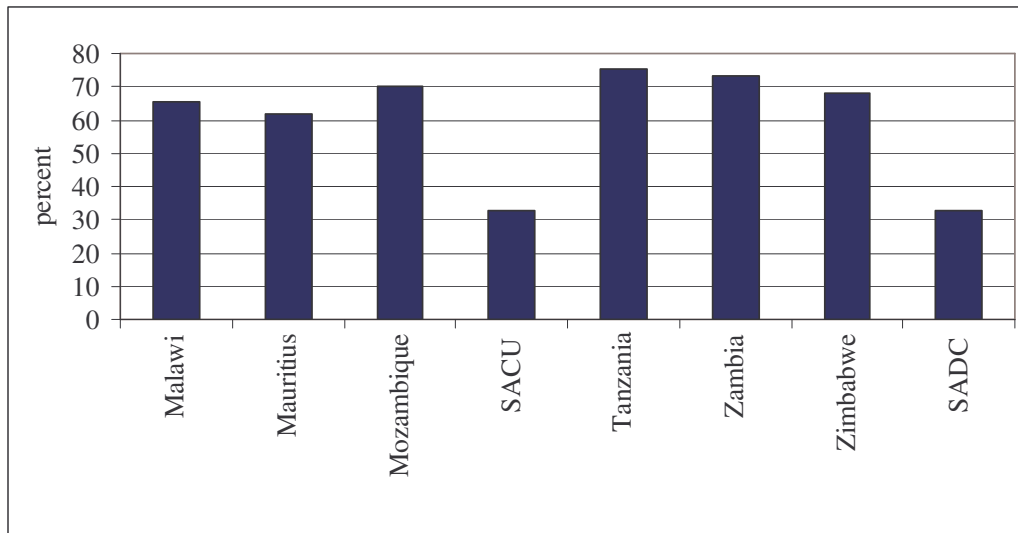
We assess the trade potential using two main indicators. Firstly, we look at the concentration of intra-SADC trade flows. Secondly, we analyse the similarity in export structures across SADC economies. Of main interest here is the similarity in the structure of exports of each SADC country to the region with that of the rest of the world. The greater the similarity in exports structures between the partner and the rest of the world, the greater the likelihood of trade diversion (Evans et al., 2006). While this diversion is of course of considerable benefit to the SADC member who is able to displace exports from the rest of the world, the importer may suffer large losses in tariff revenue with minimal gains to consumers in the form of lower prices. This is particularly the case if the regional exporter is not internationally competitive and high MFN rates are retained under the CET.

To assess concentration of intra-SADC trade flows, we analyse the share of total exports to SADC accounted for by the 10 largest export products (according to HS 6-digit lines) by value. This represents less than 0.17 percent of all product lines. The results for each country are presented in the appendix and in Figure 5 below.

We find that trade flows by countries within the region are highly concentrated in a few products. The top 10 products exported account for 60- 75 percent of total exports to SADC in each country excluding SACU.² For SACU, the share is 33 percent, although this hides much higher concentrations in Botswana, Namibia, Lesotho and Swaziland.

² The concentration of exports is starker if we look at the share in total exports to SADC accounted for by the two most important products (Table 1 in appendix). These two lines account for 50 percent or more of total exports to SADC in Zambia, Tanzania and Mozambique, and between 33 percent and 45 percent in Mauritius, Zimbabwe and Malawi.

Figure 5: Top 10 exports to SADC as share total SADC exports



Trade is also mainly in primary commodities, although Mauritius and Malawi are also exporters of clothing and textile products (Table 5 in appendix). The high product concentration of exports, which are largely commodity based, implies that intra-industry trade flows are extremely low.³ The gains from trade are therefore likely to be of the standard inter-industry type. Many of the gains from deeper integration, which arise from relocation of production, exploitation of economies of scale, productivity gains driven by product innovation and an increase in the variety of products traded are unlikely to be a major source of gains in the short run. Over the long-run, however, there may be opportunities for specialisation in processes along the production chain (vertical integration). Many of the products are intermediate inputs and are sold largely to the South African market. The strengthening of these supply networks may be an important source of growth in the future.

The very high concentration of exports also implies that each country's exports to SADC do not resemble the rest of the world's exports to SADC.⁴ There is little chance, therefore, that the FTA or CU will lead to significant diversion of imports from the rest of the world to SADC members. The potential for significant increases in intra-regional trade flows appears low, at least on the basis of current trade patterns. This is consistent with the gravity model results of Foroutan and Pritchett (1993) for sub-Saharan Africa.

The exception is SACU (mainly South Africa) whose export structure to SADC is reasonably similar to Rest of World Exports to SADC. This is clearly shown in the positive relationship between export shares in

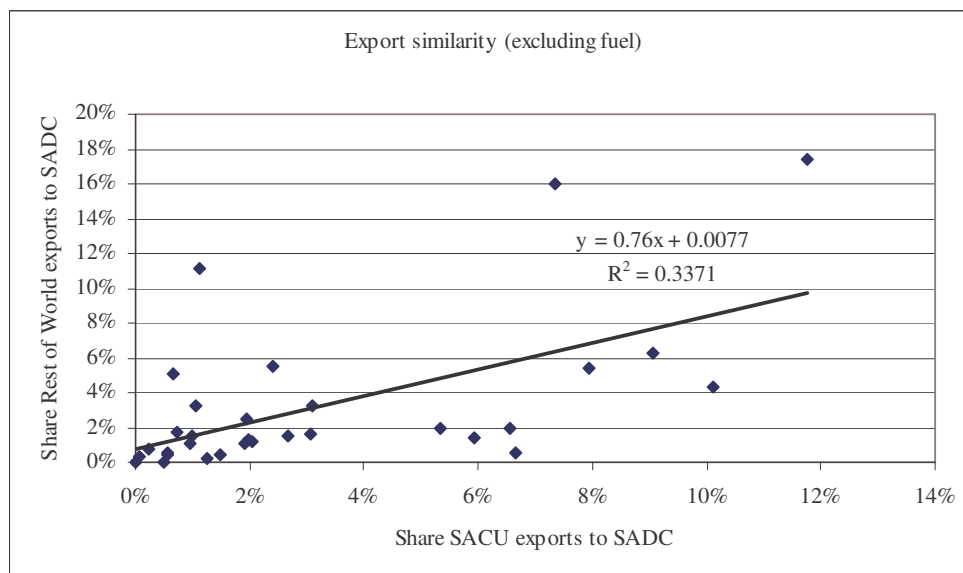
³ Intra-industry trade occurs if similar products are exported and imported.

⁴ We also show this using Finger-Kreinin index of similarity (Table 6 in appendix).

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Figure . The current FTA may therefore lead to trade diversion from the ROW to SA. While the diversion of trade to South Africa is advantageous to South African exporters, it is at the cost of SADC members in terms of both customs revenue and consumer welfare. To minimise the losses to trade diversion, the rest of SADC should consider reductions in their MFN rates.

Figure 6: Export similarity between rest of world and SACU



4. Tariffs and other barriers to trade

4.1. Tariffs on external trade

An evaluation of MFN tariff structures across SADC members provides some insight into the likely economic effects from integration. In standard economic theory, the benefits of a CU are greater the higher are the initial tariffs within the region, and the lower the common external tariff. High external tariffs lead to trade diversion. A reduction in the CET combined with internal liberalisation will therefore minimise the effects of trade diversion, while maximising the possibility of trade creation.

Our main insights can be obtained from two tables: Table 9 summarizes the MFN tariff rates applied by each SADC economy, while Table 10 presents the import weighted average tariff by sector.

Firstly, the average level of protection is similar across most of the economies (DRC, Madagascar, Malawi, Mozambique, Tanzania, Zambia and Zimbabwe) and ranges from 12 to 15 percent. This puts these economies in line with the average for lower middle income economies (11.4 percent) and low income economies (12.6 percent) in the rest of the world.

Secondly, Mauritius with an average tariff of 3.1 percent and to a lesser extent Angola (7.1 percent) and SACU (8.2 percent) have much lower average tariff rates. In the case of Mauritius and SACU, much of this is driven by the high proportion of duty free lines (53%). Nevertheless, these averages are substantially lower than their counterparts implying that for convergence to a CET, some SADC economies will be required to make considerable changes in their external tariff rate.

Thirdly, the MFN tariff structures vary enormously in terms of complexity. Most noticeably, SACU still has 100 tariff bands (including non-ad valorem rates), although this is a vast improvement on the complexity in the early 1990s. The complexity of the SACU tariff structure will constrain the negotiation of a CET. The remaining SADC economies, with the exception of Mauritius and Zimbabwe, have far fewer bands ranging from 4 to 11..

Fourthly, large numbers of tariff peaks, defined as tariff rates above 15 percent, are applied by the majority of the SADC economies. Between 33 and 41 percent of all tariff lines in DRC, Madagascar, Malawi, Mozambique, Tanzania, Zambia and Zimbabwe have tariff rates in

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excess of 15 percent. In contrast, less than 10 percent of tariff rates exceed 15 percent in Angola and Mauritius, and the proportion for SACU is 22 percent.⁵

Fifthly, we find a reasonably high degree of correlation in weighted average tariff levels across industrial sectors for some of the countries (Table 10 and

Table 11). Madagascar, Mozambique, Zambia, DRC and Tanzania have reasonably similar levels of tariff protection at the HS 6-digit level with a number of cases where the correlation coefficient exceeds 0.5. In contrast, the structure of tariff protection for SACU, Malawi and Mauritius are only weakly correlated with each other and the remaining SADC economies.

Finally, if we identify sensitive industries as those with import weighted average tariffs of 20 percent or more, we find some important differences across countries (Table 10). Beverages have relatively high tariffs for Angola, Mauritius, Tanzania and Zimbabwe. Protection on clothing, leather, footwear, furniture and wood products are generally high for most economies, with exceptions in the case of Mauritius, Zimbabwe and Angola. Vehicles have very high protection in SACU and Zimbabwe and low tariff rates in the remaining economies. Variation in average tariff rates across countries is also found in plastics, glass products and rubber products.

Table 9: Structure of MFN tariffs applied by SADC economies, 2006

	Ang	DRC	Mad	Mal	Mau	Moz	Tan	Zam	Zim	SACU
Number of tariff lines	5,224	5,224	5,222	5,112	5,224	5,224	5,212	5,224	5,224	6420
Number of bands	7	5	4	7	21	5	11	4	17	100
Duty free lines (% total)	0	0	2	9	86	2	37	22	15	53
Non-ad valorem (% lines)	0.8	0.3	0	0	2.8	0	0.2	0	-	2.9
Tariff quotas	0	0	0	0	0	0	0	0	0	0
Binding coverage (%)	100	100	29.7	31.2	17.8	13.6	13.4	16.7	21.0	96.6
Simple average	7.1	12.0	13.3	13.1	3.1	12.1	12.7	13.9	15.0	8.2
Weighted average	6.3	11.4	9.1	10.3	2.0	9.2	9.2	10.6	16.2	7.4
Maximum rate	30	30	20	30	30	25	100	25	100	108
Minimum rate	0	5	0	0	0	0	0	0	0	0
Agricultural products	11.4	14.1	16.1	15.3	6.8	18.9	21.6	20.0	24.4	9.4
Non- agricultural products	6.5	11.7	12.8	12.8	2.5	11.0	11.2	12.9	13.5	8.0
Domestic spikes (3*average) (% lines)	2.2	0	0	0.0	14.8	0	0.5	0	1.0	8.8
International (>15%) (% lines)	9.5	35.2	40.9	36.7	7.7	35.0	40.7	33.2	36	21.9
Nuisance (0<t<2%) (% lines)	0.8	-	-	-	-	-	-	-	-	1.3
Coefficient of variation	0.92	0.51	0.44	0.72	2.55	0.80	0.91	0.66	0.90	1.35

Source: TRAINS database and World Trade Profiles (2006)

Table 10: Import weighted average tariffs by sector.

	Ang	DRC	Mad	Mali	Mau	Moz	SACU	Tanz	Zam	Zim
Agriculture	8.1	7.8	8.1	9.9	1.1	4.3	2.9	14.1	13.2	25.6
Coal mining	5.0	5.1	5.0	0.0	0.0	2.5	0.0	0.0	15.0	5.0
Gold mining	0.0	20.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	15.0
Other mining	17.4	7.5	7.1	1.2	0.3	6.7	0.0	5.5	0.5	6.1
Food	9.4	13.2	8.5	14.0	3.9	11.4	10.5	19.5	18.3	20.8
Beverages	28.0	15.1	12.8	13.8	25.2	15.7	2.7	19.7	15.1	37.8
Tobacco	29.9	20.0	20.0	25.0	29.9	25.0	19.0	21.7	24.9	1.9
Textiles	10.3	16.9	18.5	21.4	0.5	19.9	16.8	17.7	18.1	18.1
Clothing	14.6	19.7	19.9	25.0	0.4	24.9	35.6	25.4	25.0	6.4
Leather prods	19.5	18.0	19.8	25.0	5.5	22.7	19.9	24.8	24.6	6.8
Footwear	9.9	19.8	19.8	25.0	3.4	24.2	29.2	25.0	24.7	5.2
Wood & prods	20.4	19.7	19.6	23.0	1.7	8.0	4.4	24.1	24.8	23.4
Paper & prods	10.1	14.5	16.2	8.2	2.8	7.4	4.5	19.4	12.8	20.6
Printing	9.8	17.3	18.4	1.8	2.2	4.4	1.0	11.5	7.6	6.8
Petrol ref	12.0	10.0	0.1	9.8	0.0	6.4	0.4	10.1	13.4	20.3

⁵ Note, if zero tariffs are excluded then over 40 percent of SACU tariff lines have tariff rates in excess of 15 percent.

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Basic chems	3.1	6.3	6.3	2.0	0.8	2.6	1.8	0.6	1.5	5.4
Other chems	9.4	15.6	6.1	6.0	3.8	7.4	2.2	5.4	7.6	12.0
Rubber prods	6.9	12.7	19.4	20.3	17.4	15.7	14.0	10.5	23.8	16.7
Plastic prods	14.5	14.8	16.1	15.4	6.3	14.7	12.1	20.6	21.0	23.1
Glass & prods	7.7	18.8	12.4	21.3	6.4	10.4	6.9	14.6	13.4	24.5
Non-met mins	12.5	16.1	12.1	11.3	4.1	7.9	6.2	23.1	12.2	14.4
Bas iron & st	4.8	12.3	12.1	10.0	1.5	6.4	1.8	4.2	6.5	13.9
Bas n-fer met	2.0	12.5	9.6	5.4	0.0	5.8	0.5	4.0	9.5	7.2
Metal prods	13.6	12.1	13.0	17.6	1.3	9.2	6.6	11.5	16.3	23.3
Machinery	2.5	7.2	10.7	7.2	0.6	7.0	1.0	3.9	8.2	7.2
Electr mach	2.9	8.9	11.3	10.3	5.2	7.0	5.1	5.2	13.1	17.0
Tv & coms eq	6.4	11.2	17.8	9.5	1.0	12.1	1.9	11.2	16.3	15.0
Scientific eq	2.3	6.2	10.3	6.0	0.3	6.8	0.1	1.2	9.6	7.1
Motveh & parts	6.4	9.2	11.9	13.5	3.7	9.0	26.2	11.0	16.8	30.1
Oth trnsp eq	2.0	11.6	15.1	11.3	0.3	8.4	0.3	9.0	8.3	9.2
Furniture	14.6	19.8	19.8	25.0	15.9	24.3	16.6	25.0	25.0	37.7
Oth industr	10.5	12.9	16.2	24.5	2.3	22.3	3.5	37.3	22.7	14.8
Grand Total	6.3	11.4	9.1	10.3	2.0	9.2	7.4	10.0	10.6	16.2

Note: Angola, SACU, Madagascar, Mauritius, Mozambique use 2006 tariff rates. 2003 values are used for DRC, Zimbabwe and Tanzania. 2001 values are used for Malawi.

Table 11: Pairwise correlation coefficients of sectoral tariff rates

<i>year</i>	Ang 2006	SACU 2006	DRC 2003	Mad 2006	Mal 2001	Mau 2006	Moz 2006	Zam 2005	Zim 2003
Angola	1.00								
SACU	0.35	1.00							
DRC	0.52	0.47	1.00						
Madagascar	0.48	0.49	0.66	1.00					
Malawi	0.14	0.32	0.27	0.24	1.00				
Mauritius	0.28	0.20	0.30	0.32	0.11	1.00			
Mozambique	0.50	0.54	0.67	0.74	0.32	0.31	1.00		
Zambia	0.54	0.47	0.65	0.63	0.28	0.33	0.68	1.00	
Zimbabwe	0.29	0.19	0.41	0.42	0.12	0.34	0.43	0.44	1.00
Tanzania	0.51	0.55	0.71	0.69	0.30	0.35	0.73	0.69	0.49

Notes: Based on average tariffs at HS6-digit level

4.2. Barriers to intra-regional trade

The SADC Free Trade Agreement entered into force in January 2000 and is expected to result in a WTO-compliant free trade area by 2008. Currently, 11 of the 14 SADC member states have begun to phase-down tariffs on internal trade, with Angola and the Madagascar to follow soon. The DRC is the only SADC member state that has not acceded to the Trade Protocol. The status and success of the SADC Free Trade Area will have a major bearing on the shape and schedule of the SADC Customs Union.

SADC has recently concluded a 'Study on the Implementation of the SADC Protocol on Trade' and the main, relevant results from this study are summarised below:

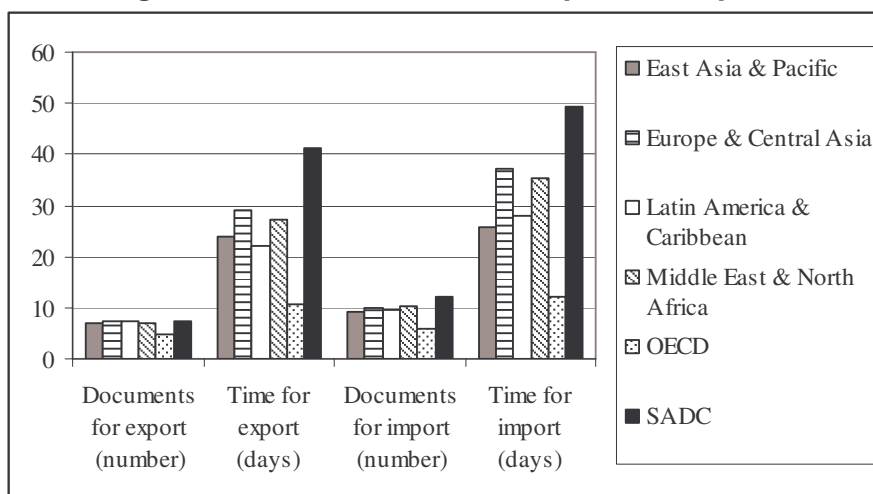
- At the conclusion of the Trade Protocol in 2012, some countries will retain a wide range of permanent exclusions on imports from South Africa.
- Four member states are behind on the implementation of their tariff phase-down schedule and in some cases reductions that have taken place are less than initially scheduled.
- Out of the 11 SADC member states that have implemented the Trade Protocol, 5 are also members of COMESA, five members of SACU and one a member of the East African Community.

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- With the exception of Lesotho and Zambia, all signatories to the Trade Protocol have entered into preferential or bilateral agreements with other members or non-members of SADC.
- Countries that are members of other customs unions have implemented tariffs on imports from SADC in accordance with the other CU CET regardless of commitments made under the SADC Trade Protocol.
- SACU has provided preferential access (more liberal rules of origin) to some SADC member states for certain textile products but has denied the same access to other members.
- Rules of origin in SADC are overly complex, contain many restrictions and discourage intra-regional trade.
- Member countries have begun implementing most of the SADC trade facilitation instruments but there is a lack of capacity and equipment at many borders to administer these agreements and there a lack of uniformity between member states in the application of customs procedures.
- Transit costs and delays are significant, particularly for landlocked member countries
- Some member states impose stringent visa conditions of nationals from other SADC member states.

Further evidence on the impact of border and transport barriers to internal trade is available from the World Bank Cost of Doing Business Indicators (World Bank, 2007) and the Global Competitiveness Report (2006). The results are striking. Firstly, trade facilitation barriers to trade are substantially higher in SADC than in all other regions. On average, it takes 49.5 and 41 days to comply with all procedures required to import and export goods, respectively, exceeding 60 days in 5 SADC member countries. The best performing economy is Mauritius which requires only 16 days to comply with all requirements required to export and import.

Figure 5: Documents and time for exports and imports



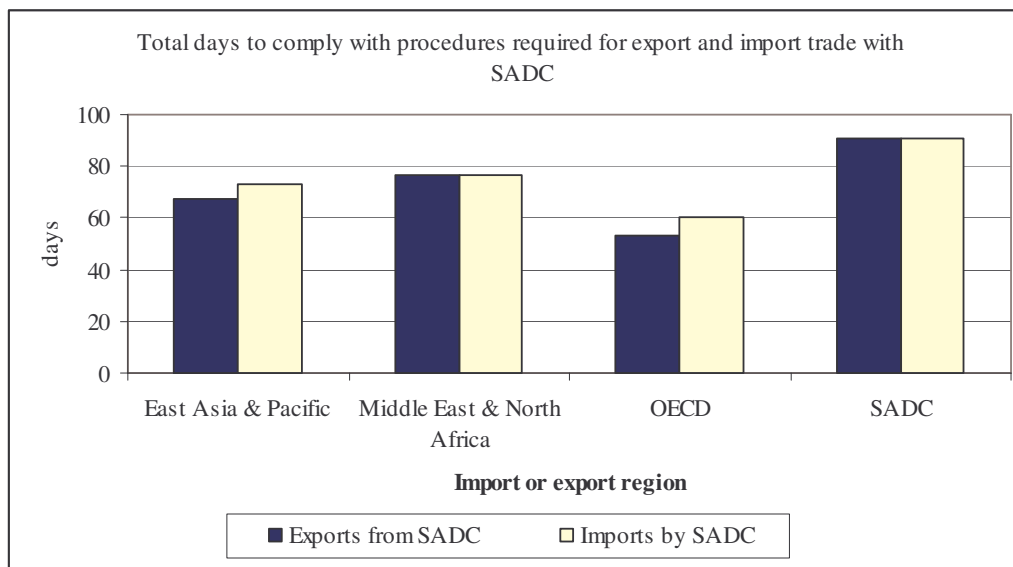
Source: Own calculations using World Bank Doing Business Survey (2007)⁶

⁶ All documents required to export and import the goods are recorded. It is assumed that the contract has already been agreed upon and signed by both parties. Documents include bank documents, customs declaration and clearance documents, port filing documents, import licenses and other official documents exchanged between the concerned parties. Documents filed simultaneously are considered different documents but with the same time frame for completion. Time for exports or imports is calendar days necessary to comply with all procedures

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The procedural requirements to export and import goods, are even more detrimental to intra-SADC trade. Figure 6 presents the average number of days SADC economies need to comply with export and import procedures when trading with different regions. The total days are calculated by summing the days required by the export country, with those required by the import country.⁷ On average it takes 91 days to comply with all of the trading requirements for intra-SADC trade, compared to 53-60 days for trade between SADC and the OECD.

Figure 6: Average days to comply with procedures required for export and import trade with SADC region, by region



Source: Own calculations using World Bank Doing Business Survey (2007)

Note: Total days reflect the sum of days required to comply with exports by export country and days required to comply with imports by importer country.

Transportation costs are also high in SADC economies relative to other regions. On average, the costs for SADC economies to complete the procedures to export or import goods to or from the rest of the world exceed US\$1,500 per 20-foot container. These fees include costs for documents, administrative fees for customs clearance and technical control, terminal handling charges and inland transport. The fees for OECD countries, in contrast, average around US\$ 850, i.e. close to half that of SADC (World Bank, 2007). There is substantial variation in these costs within SADC economies, with below average costs for exports from Mauritius, South Africa, Tanzania and Botswana.

Finally, measures of port and air infrastructure quality are also found to be poor relative to the world average for a number of SADC economies. Only South Africa and Mauritius perform relatively well in terms of these measures.

It would appear that the key constraints to internal trade are well known and numerous agreements and programmes have been initiated to deal with these. But progress against these agreements is patchy and is made more difficult by the terms of the trade protocol (rules of origin in particular), overlapping membership with other regional integration initiatives, and low levels of capacity or commitment within member states to fully implement

required to export/import goods. The time calculation for a procedure starts from the moment it is initiated and runs until it is completed.

⁷ We only have average data for each country. Hence this measure is only a proxy of the true costs by region. Further, we take the simple average, rather than the trade weighted average. Trade weighted averages are biased downwards as bilateral trade flows are expected to be lower where barriers to trade are highest.

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the conditions of these agreements at internal border posts. Unless infrastructure and trade facilitation barriers are reduced, the full gains from a reduction in intra-regional tariffs may not be realised.

4.3. Other tariff considerations: The problem of the EU's EPAs and overlapping membership

The shape of the SADC customs union will also be influenced by a number of other regional and external initiatives, such as developments within SACU and COMESA and the negotiation of Economic Partnership Agreements (EPAs) with the EU.

The EPA negotiations have not been completed, which gives rise to a number of questions regarding the formation of a SADC CU. For instance, how will the possible creation of EPAs in SADC alongside the existing TDCA assist or hinder the SADC CU? Will the EPAs 'mould' the CU, affecting the choices that Governments can make from the range of options described in Section A above by establishing a new set of external parameters to which it must conform? The answer will depend on the choices that countries make over whether to join an EPA and, if they do, which goods they will liberalise and when. But analysis of possible EPA configurations indicates that there could be substantial problems.

The nature of the problem

Regardless of which type of customs union a region opts for, the CET must cover not only MFN but also preferential trade partners. They are particularly severe in a classic CU that also involves internal free trade: unless there are common preferential tariffs, members cannot dispense with rules of origin for internal trade due to the same dangers of trade deflection that arise from differing MFN rates.

The negotiations with the European Union can have two negative outcomes. One is that SADC states may not join the CU once one or more of their members have signed up to an EPA. Whilst a country might have been willing to remove barriers to imports from its neighbours with similar economies, they might be unwilling to offer the same terms to highly competitive EU imports that will enter the CU via a member that has agreed to remove all tariffs and quotas on the relevant imports from the EU.

The other danger is that the EPAs could influence the speed at which a SADC CU is implemented. If EPAs are implemented over up to 25 years they may provide new reasons not to remove intra-regional border controls. For example, if country A excludes flour from liberalisation from the EU and maintains a 100 percent tariff but its neighbour, B, removes all duties, traders may circumvent A's restrictions by transporting EU goods across the border from B. To avoid this, either the tariff difference between A and B must be sufficiently small to make such trans-shipment commercially unviable, or rigorous border controls must be maintained to prevent trans-shipment (that would undermine A's milling industry). Retaining these border controls undermines the achievement of internal free trade and, hence, reduces the economic gains.

Until the EPAs have been concluded and their membership and details are known, it cannot be known for certain how the tariff schedules of the potential members of a SADC CU will be affected. But studies based on hypothetical schedules that reflect the current pattern of countries' applied tariffs, indicate that there is high potential for incoherence⁸.

Timetables and negotiating fora

A part of the problem is that the 'EPA tail may wag the CU dog': the EPAs are set to come into effect in 2008 and be implemented over the period 2008-2033. This means their provisions will be established before the 2010 deadline of the SADC CU *and* will be

⁸ Stevens, C and Kennan J 'SADC Trade Integration: the Challenge of EPAs' in Proceedings of the 2006 FORPRISA Annual Conference FORPRISA Report 3 (BIDPA, Gaborone, 2007); Stevens, C. 'The EU, Africa and Economic Partnership Agreements: unintended consequences of policy leverage', *Journal of Modern African Studies*, Vol. 44, No. 3: 1-18. (2006)

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implemented for many years afterwards. This in turn means that the binding commitments in any EPA that has been agreed before 2010 will either have to be renegotiated or accommodated by the CU.

The problem is exasperated by the fact that the SADC states are negotiating with the EU in two separate groups. The Eastern and Southern Africa (ESA) group appears to be aiming for an EPA schedule that reflects the COMESA CU commitments. To the extent that this objective is achieved it will require the SADC CU to take into account, in its preferential rates for the EU, the COMESA provisions. If it is not (wholly) achieved, the SADC CU will need to accommodate the separate schedules of the SADC states that have been negotiated under the ESA banner.

In both cases it will be necessary to accommodate any provisions in the ESA EPA that relate to the common trade policies that are agreed under the SADC CU. If there exists any incompatibility between the provisions in the ESA and SADC EPAs, the CU will have to find some way of accommodating the differences.

Different liberalisation schedules

Even among the countries negotiating under the SADC EPA umbrella, there are likely to be differences between countries both over the products favoured for exclusion from liberalisation and also over the number of such products. The reason for the first difference is clear: countries have different priorities for the sectors they wish to protect from import competition and the goods on which they wish to raise tariff revenue. The second arises because the composition of each country's imports from the EU varies and so the excludable proportion is calculated by each state against a different base. Take the case of Lesotho and Botswana. As members of SACU they have identical tariffs. Even so, if both chose to exclude from liberalisation the items they imported from the EU in 2003 that faced the highest tariffs, Lesotho would not need to liberalise on anything as over 80 percent of its imports already face zero tariffs, but Botswana would have to remove tariffs as high as 42.5 percent.⁹

In the absence of agreed EPA positions, analysis so far has been based on the assumption that countries aim to exclude from liberalisation the goods that currently face the highest applied tariffs and to defer for as long as possible the liberalisation of items that face slightly lower tariffs. Although these assumptions cannot reflect what governments actually decide to do, the results of the analysis are important. This is because they indicate, at minimum, the extent to which countries will need to alter their existing tariff policies in order to make an effective CU feasible. The current applied tariffs are the embodiment of current trade policy for border restrictions on market access for goods. If the continuation into an EPA of current policy creates problems for the CU, the underlying policy will need to be changed to remove the problem.

The results provided by the studies cited suggest that there is almost no coherence between the hypothetical EPA liberalisation schedules of neighbouring countries. They find that there are many goods that one SADC country might exclude from liberalisation and its neighbour might liberalise. In cases where the tariff difference between the 'liberalising' and the 'non-liberalising' country is high, there is an incentive for smugglers to spirit EU goods over the border from the former to the latter – and hence an incentive for the latter to retain rigorous border controls to avoid this.

The most frequent occurrences of incoherence between neighbouring countries are in relation to cotton and textiles and electrical machinery. Paper, meat, iron and steel articles and vegetables are also frequently encountered problem items, as are precious metals.

⁹ Stevens, C. and J. Kennan. 'Assessment of the Proposed Reform of the Generalised System of Preferences', report prepared for the European Parliament. Brighton: Institute of Development Studies. (2005)

5. Implications for the CU and the determination of a CET

Vast differences in industrial structure and level of development pose challenges, but also opportunities, for the formation of a CU and the determination of a common external tariff. On the one hand, countries are likely to differ in their views on the desirability of deeper integration and of particular tariff structures and levels. On the other hand, low levels of intra-regional trade and the lack of overlap in industrial structure implies industrial interests and competition may not derail the formation of a CU.

Intra-SADC exports by SADC members (excluding SACU) are highly concentrated in a few products and do not match current imports by the region. South Africa is an exception to this. It dominates the region in terms of its economic size and manufacturing base and exports a diverse range of products to SADC countries, many of which are currently imported from the rest of the world.

Existing patterns suggest as well that there is little scope for gains in intra-industry trade. Manufacturing accounts for a small proportion of overall production in most SADC economies and is highly concentrated in a few sectors. The gains from trade will be largely of the inter-industry type, although there may be opportunities for specialisation in processes along the production chain (vertical integration). Thus, whereas deeper integration might contribute to enhanced intra-regional trade, gains are likely to be more substantial if the CU is used as a mechanism to facilitate greater openness to and competitiveness in the global economy. This, in turn, requires a low and simple CET. Existing trade patterns suggest that the retention of high MFN tariffs within a more integrated CU may lead to increased trade diversion, particularly in relation to South Africa.

SECTION C: MODALITIES FOR A CUSTOMS UNION

1. Types of integration

The primary objective of this study is to recommend an 'appropriate model' for a SADC Customs Union (SADC CU). Part of this decision is economic and we can draw a number of key lessons from the economic experiences of other regional integration initiatives and from the revenue and economic impact analysis presented later in this paper. But most of the economic gains from deeper regional integration do not depend on the creation of a customs union. This raises a number of additional questions to be considered in determining the future direction and shape of SADC.

What must the SADC CU achieve? What *can* a CU achieve? It is the answer to these questions that will determine the 'appropriate model' for deeper integration in SADC. Only SADC Governments can answer the first question. The task of this study is to inform their choice by providing answers to the second question. The term 'customs union' covers a range of scope and practice, with different configurations producing different results.

In this section, we describe some of the key issues to be considered and structural choices to be made in determining the shape of a SADC Customs Union. From this, we are able to derive a limited number of 'models' to be evaluated in the revenue and economic analysis .

2. The terminology for economic integration schemes

Much confusion is induced by imprecise terminology and so the following definitions are used in this report. Balassa identified five different regional *economic* integration forms. This distinction – that the point of reference is *economic* integration - is important because there are also political objectives for integration, some of which overlap and reinforce the economic ones, but others of which can be achieved in quite different ways¹⁰.

The forms identified by Balassa are normally considered to represent a progression, with each being a further step on the road to economic integration than the ones that come before. But, as suggested below, this need not always be the case. The five are as follows.

1. **Preferential Trade Arrangement (PTA)** which is the simplest form of economic integration; it requires only that participating countries grant each other preferential (but not necessarily free) access to each others markets.
2. **Free Trade Area (FTA)** in which both tariffs and quantitative restrictions (QRs) are abolished between member countries which, nonetheless, retain their own external tariffs (on imports from outside the FTA) and so do not have harmonised trade policies. Differences in external tariff rates generally make it necessary to impose rules of origin on intra-group trade.
3. **Customs Union (CU)** in which members establish a *common customs area*. At a minimum this generally requires a common external tariff (CET) on imports from non-members and no import tariffs on trade among members. This has additional implications for the use of anti-dumping and other contingent protection measures, for rules of origin (depending on the revenue collection and distribution arrangements chosen, they may not be needed) and also for the rules governing the operation of export-processing zones and the granting of other fiscal privileges for goods shipped outside of the customs area. CUs are also assumed, normally, to involve the same abolition of internal tariffs and QRs as an FTA and, as such, to be 'the next step'.

¹⁰ It is wrong to assume that the path towards social or political integration always starts with trade. The Nordic Passport Union of 1954, for example, allows free movement of people between the Nordic Group and illustrates the close co-ordination between these countries in a wide range of areas. It was merged with the EU's Shengen Accord in 1996, leading to the 'interesting situation' in which Norwegians have free movement within Shengen countries (and vice versa) even though Norway is not in the same economic union as the other countries.

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4. **Common Market**, which is a CU that allows the free movement of capital and labour among members and a harmonisation of trading standards and practises, together with a common trade policy towards third parties that goes beyond simply a CET.
5. **Economic Union** in which the members of a common market also harmonise their economic policies including some coordination of monetary and fiscal policies, and also transportation and competition policies.

While this taxonomy is helpful as a starting point, it leaves many considerations aside, especially with regard to issues such as trade in services and cooperation to improve trade facilitation within and outside the group of countries in question. In moving from an FTA to a customs union it might be expected that more progress would be possible in dealing with these “deeper integration” issues. Indeed this might be one of the main benefits of forming a common customs area.

SADC currently rests somewhere between the first and second steps in this progression. It has made good progress towards the achievement of a regional-wide preferential trade agreement, but has some way to go in terms of providing for free internal trade. Completing this second step would seem to be a logical but not necessary pre-condition to moving further down the Balassa continuum towards a Customs Union.

The main hurdles in getting from preferential trade to free trade within a customs union are the abolition of all internal restrictions on trade and the establishment of a common external tariff. Different customs unions have dealt with these issues in different ways and in most instances, the move to free internal trade and a common trade policy is incomplete. The experiences and practices of existing customs unions are reviewed in more detail below.

3. Procedures and institutions

3.1. The range of practices reviewed

A wide range of practice exists in groups that all share the title of ‘customs unions’. This subsection reviews key features of the evolution and current practice of five regional integration schemes that illustrate different types of membership, scope and progress. They are:

- the EU, which has gone further than any other regional integration scheme;
- the Caribbean Community (CARICOM), which contains both more and lesser developed countries, has a partly regionalised trade policy negotiation system, and shares as a common legacy not only history but also language, legal and educational systems and relatively free movement of labour;
- the East African Community (EAC), which has a limited membership and a clearly articulated plan to complete the CU within a relatively short period of time;
- the Central American Common Market (CACM), which has made substantial progress in recent years around a common, low-tariff policy and with a close eye on the need for members to have parity in access to the US market not only with each other but also with other states in the region;
- the Mercado Común del Sur (MERCOSUR), which forms a valuable contrast with CACM, modelled along structuralist lines with the intention of building a protected regional market that is sufficiently large to support the development of industrial and manufacturing capacity.

It is neither feasible nor helpful to provide in this report a comprehensive description of the legal regime in each of these CUs and the extent to which the law is applied in practice. This would require a report for each CU and is not what is required at this stage. Instead, this study has analysed the features and experience of the five CUs that are most relevant to the choices facing SADC. Revenue collection, because it is so important a feature of CUs, is covered separately in Section C.

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The areas in which practice on goods trade varies between CUs and the architects of the SADC regime have a choice include the following.

1. The required degree of uniformity in any MFN tariffs (is any latitude possible between the regimes applied by members)?
2. The practical treatment of goods, including:
 - freedom of transit;
 - valuation of goods;
 - internal customs controls;
 - special and differential treatment (SDT) between members.
3. The required degree of uniformity if any for any 'better-than-MFN' tariffs (can members have different preferential regimes)?
4. The transition periods that can be allowed for reaching the required degree of uniformity.
5. The required degree of uniformity for any non-tariff barriers (NTBs) including
 - Safeguards and antidumping operations;
 - Technical regulations, standards, sanitary and phytosanitary standards (SPS) and rules of origin.
6. Export assistance regulations.
7. The existence of a common competition policy.
8. The organisation of trade policy negotiation.
9. Common institutions to support the CU.
10. The arrangements for dispute settlement within the CU.
11. Informal revenue sharing arrangements (as opposed to the formal arrangements covered in Section C) including both development and social funds and also undertakings like the EU's Common Agricultural Policy (CAP) whereby some areas of public expenditure are designed specifically with the interests of some members in mind.

This list, long though it is, covers just trade in goods. In addition there is the question of whether services trade has to be liberalised as part of a functioning CU.

3.2. The lessons for SADC

The experience of the five reviewed CUs on all eleven issues is summarised in Table 12. Among the key lessons are the following.

Transition periods are long and implementation partial

Creating a CU that functions in the ways assumed in the textbooks takes time. Even the **EU** took eleven years from its creation in the Treaty of Rome to the completion of a CET in 1968. The experience of other regions has been equally complex and in many instances country or sector-specific exceptions to the CET remain.

In the case of **CARICOM** it took four years of negotiation for member countries to adopt, in January 1993, a CET for all goods *except* agriculture. This was supposed to be implemented in four phases by 1998¹¹. The CET was not implemented in time but is now largely in place (on paper if not necessarily in practice).

¹¹ In the first phase, the initial ceiling of 35 percent would be lowered to 20 percent but agricultural goods continued to command a 40 percent tariff. The second phase of liberalisation was to last from January 1, 1995 to

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CACM agreed to develop a free trade zone and adopt a CET in 1960. A free trade regime was established for almost all products originating in their respective territories and CACM has succeeded in unifying tariffs on 94.6 percent of the headings contained in the Central American Tariff System. A strategy has been defined for tariff harmonisation on the remaining, mostly agricultural products.

Although **MERCOSUR**'s CET has applied (with some exceptions) to trade with non-members since January 1995, a transition period was provided for some products and sectors for moving towards full conformity with the CET. Moreover, the CET agreed in 1995 included a number of sector- and country-specific exceptions. Sector-specific exceptions were due to be removed progressively by 1 January 2006, and country-specific exceptions to converge to the CET by 1 January 2001. The latter deadline was not met.

Variation still exists on nominal and effective CETs

The average applied tariff in most of the CUs is moderate. In the EU it is 6.9 percent (though with a maximum *ad valorem* equivalent of over 400 percent). In the EAC it is 12.9 percent (with 99 percent of tariffs set in three bands of 0, 10 or 25 percent and only 58 lines set at higher rates). And in CARICOM it is 10 percent (half the 1990 level), with higher than average tariffs for food and manufactures.

But these agreed rates have been achieved partly by allowing exemptions of various kinds from the CET. The **CARICOM** CET is not really common because it offers broad scope for tariff suspensions and reductions as well as for national derogations. These exceptions and derogations not only complicate external trade negotiations but also increases transaction costs and reduce transparency. Tariff harmonisation and reduction is particularly difficult for the Eastern Caribbean countries which rely heavily on customs revenue as an income source.

In the **EU**, value-added tax and excise duties apply to imports and locally produced goods at rates that are set by Member States. Despite attempts in the late 1980s to do so, VAT and excise rates are not harmonised within the EC. Some national excise duties relate to goods that are wholly or largely imported, with the effect that the total tax liability of imports differs between member states.

In **MERCOSUR** the CET does not cover all sectors. The basic list of exceptions (LBE) agreed for the transition period was replaced by a list of 100 items that ends in December 2008. The automotive sector is governed by a special regime, as is the sugar sector.

There are a few national exemptions from the **EAC** common external tariff: for a period of 24 months ending on 30 June 2008, Kenya is allowed to impose lower tariffs on rice imports from Pakistan and Tanzania is allowed to impose lower tariffs on imports of wheat (10 percent instead of 25 percent) and barley (0 percent instead of 10 percent).

Moreover, derogations and safeguards are widely used in all the CUs except the EU and CACM. For example, resolution 69/00 of the Common Market Group of **MERCOSUR** allows members to reduce or raise CET rates temporarily under specific conditions and with some limitations¹². Following the 'peso crisis' Argentina raised tariffs to 35 percent on numerous consumer goods and cut the tariff on capital goods imported from outside the zone to zero percent. This policy was partially reversed following the peso devaluation, and the tariff increases were phased out in December 2003.

December 31, 1996, with a ceiling of 30 percent. In the third phase, during 1997, the tariff ceiling was to be reduced to 25 percent, and finally in the fourth phase, to 20 percent by January 1, 1998.

¹² Reductions are subject to quotas and are for a specific period, of up to 12 months; they must not cause an intra-MERCOSUR trade reduction, nor alter competitiveness conditions in the region, and must maintain a margin of regional preference. In the case of agricultural goods, seasonal supply conditions in MERCOSUR must be taken into account. The reductions may be applied to a maximum of 20 tariff headings.

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Intra-regional trade is not always free

Many transitional tariff and not-so-transitional NTBs remain to trade within all CUs except the EU. And the EU only removed the last physical, technical and tax-related obstacles to intra-Union trade in 1993, 36 years after it was founded.

The free trade area component of **EAC** implies the dismantling of tariffs on most intra-EAC trade and members began eliminating internal tariffs in January 2005. Tariffs were abolished completely on trade between Uganda and Tanzania, and on exports from these two countries to Kenya. However, various goods exported from Kenya to Tanzania or Uganda continue to be subject to tariffs. They are scheduled to be phased out by 2010. Members are also committed to removing NTBs on intra-EAC trade, but have been slow in dismantling them. EAC members have agreed to harmonise their duty and tax exemption and concession schemes. However, these have not yet been harmonised and are still laid down in national laws.

All **CARICOM** countries except Bahamas and Haiti are members of the Caribbean Single Market Economy (CSME) that entered into force in 2006 aiming to establish a Common Market. The provisions of the Revised Treaty have been largely implemented and intra-regional tariffs have been removed within the CSME. However, NTBs still hamper the free movement of goods since exceptions (such as infant industry protection or balance of payment difficulties) and are misused and discriminatory taxes applied in a number of member countries.

In **MERCOSUR** there is not yet free internal trade in sugar. In the meantime, MFN tariffs are applied with a 20 percent preference for intra-zone trade.

The removal of physical and administrative barriers is slow

CACM has made major efforts to remove direct barriers to trade – and their actions illustrate the range of measures that are needed in practice to achieve this goal. Sixty barriers to intra-regional trade identified in 2002 had already been eliminated by 2005. The main instruments adopted since 1999 to strengthen the CACM include the following:

- Regulations on the International Customs Transit Regime, which aim mainly to facilitate, harmonise and simplify procedures used in international customs overland transit operations for merchandise arriving from or originating in signatory countries, and/or third countries provided the transit operation starts in a State party.
- Central American Uniform Customs Code (CAUCA III) and its regulations, which aim to establish basic customs legislation for the countries of the region in accordance with CACM requirements and those of other regional integration instruments. This is applied throughout the customs territory to all persons, merchandise and means of transport crossing the customs boundaries of the signatory countries.
- Central American Regulations on the Valuation of Goods for Customs Purposes.
- A mechanism for the Settlement of Trade Disputes in Central America, which applies to the prevention or settlement of all disputes between members arising from the implementation or interpretation of economic integration instruments.
- An agreement to minimise physical checks on intra-regional trade, using a single-digit selection mechanism and applying intelligent controls through risk management (before, during and after execution of the operation). Given that establishment of the Central American customs union requires intra-border posts to be eliminated, it is hoped in the medium term to strengthen the outlying customs offices of the common customs area.
- Procedures for movements of merchandise and people were simplified at select border posts to reduce substantially the time taken to process migratory and customs operations. This involved the establishment of joint windows attended by staff from neighbouring countries and the electronic transmission of the Central American Uniform Customs Form (FAUCA) in intra-regional operations.

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- With the aim of streamlining trade in agricultural products, a list of 469 plant products and by-products was harmonised, which are exempt from procedures to obtain import authorisation and the phytosanitary certificate for export. A standard sanitary and phytosanitary transit instrument is being prepared for approval at the present time.

MERCOSUR is moving in a similar direction but has made less progress. In December 2004 it agreed to the elimination of double charging of the CET and the distribution of customs revenue within MERCOSUR. This decision will be implemented in two stages and implementation is subject to approval and entry into force of the MERCOSUR Customs Code and the adoption of a single MERCOSUR customs document, an understanding on the distribution of customs revenue, the interconnection of computerised customs management systems and the establishment of the Regional Registers Database of Offenders (RIM). The authorities have indicated that approval of these three requirements in order to embark on the second stage should occur by 2008 at the latest.

The principles of **EAC** customs procedures and valuation are laid down in the EAC Customs Management Act 2004. In practice customs procedures have not been fully harmonised by EAC members. Similarly, whereas Article 13 of the Protocol on the Establishment of the East African Customs Union obliges member states to remove all NTBs, with immediate effect, and not to impose any new ones, substantial progress has still to be achieved in this direction. More progress has been made on the harmonisation of standards and as at September 2005, 566 joint standards had been adopted by the Council of Ministers.

Although **CARICOM** has established the CARICOM Regional Organisation for Standards and Quality (CRQSQ) only 6 countries¹³ have to date enacted the Agreement into law. National Standards Bodies have been established in 11 member states.

Even in the **EU** full harmonisation of standards and technical regulations has not been achieved (although it goes very much further than in any of the other CUs reviewed). Products placed on the market of a Member State must comply, where necessary, with relevant national standards and Community-wide legislation. EC legislation on SPS issues is implemented by Member States in coordination with the Commission. The common SPS regime aims to provide EC exporters with technical support in SPS-related issues in third countries; comply with WTO rules and rulings; and maintain EC SPS legislation in line with international guidelines.

Most CUs have (limited) provisions on competition

There is a strong body of thought that a major (possibly the most important) contribution to the success of the **EU** common market has been a strong supra-national competition policy and a set of EU-wide laws, adjudicated by a supra-national court to which private and corporate bodies can appeal. There have been many cases of members states being forced to remove direct or indirect restrictions to trade by judgements from the European Court of Justice (from the Cassis de Dijon case onwards) or adverse competition rulings.

Other CUs have some provisions on competition, but none has an effective, supra-national competition authority.

An **EAC** Competition Bill is under consideration by the East African Legislative Assembly (as at July 2006). Within **CARICOM**, only Barbados and Jamaica have National Competition Policies. At the regional level, a Community Competition Policy has been established but it has not yet been operationalised. **MERCOSUR** concluded a Protocol on the Protection of Competition in 1996 and the regulations to this Protocol were approved by the top-level MERCOSUR bodies in the second half of 2002 (as of May 2006 these had not been ratified by the Argentine Congress). MERCOSUR States have also negotiated two four-party understandings to improve cooperation between competition protection authorities in MERCOSUR States.

¹³ Belize, Barbados, Guyana, Jamaica, St Lucia and St Vincent.

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Formal SDT is rare

Special attention can be given to the needs of lesser developed members of a CU through the application of provisions on exemptions from the CET, implementation periods, safeguards etc. But formal provisions to treat lesser developed members differently or provide them with special financial flows are rare. It is most apparent in CARICOM and the EU.

An important feature of the Treaty of Chaguaramas is the agreement on SDT for lesser developed **CARICOM** countries, which are the six Eastern Caribbean countries plus Belize. The lesser developed countries were supposed to receive special arrangements in terms of tariff reductions, revenues, internal taxation, rules of origin, and fiscal incentives (such as the imposition of capital controls) as well as the right to temporary infant industry protection. The main objective was to protect the lesser developed countries and in particular the Eastern Caribbean countries' share of intraregional trade. Though the special treatment in tariff reduction has been eliminated with the 2001 Revised Treaty, a regional integration strategy that centres on variable geometries and differentiation is still a crucial part of CARICOM integration.

The incorporation of a Development Fund underscores the recognition that SDT should not be limited only to trade provisions but must also incorporate financial provisions. A regional Development fund that seeks to provide financial or technical support through loans, grants and interest subsidies was established in 2006 and has not been implemented yet.

The **EU** has its social and regional development funds, and the European Investment Bank. But financing for the funds has been relatively modest. By far the most substantial redistributive mechanism between and within member states has been the CAP – and it is certainly not the case that it has uniformly transferred money from all the richer to all the poorer members.

3.3. Trade in Services

Services are not mentioned in Table 12 since the EU, alone among the five CUs reviewed, has attempted to remove barriers to services trade – not wholly successfully. In 2001 the EU Commission issued a synthesis of a set of studies undertaken to identify the remaining barriers to trade in services within the 'single market'¹⁴. It found numerous administrative and legal obstacles. To help classify them it broke down the business process into six stages and identified widespread barriers at each stage that could disrupt trade. A single set of barriers can disrupt trade in a cumulative fashion at various stages. The six stages of the business process for services, at each of which market access may be restricted, are as follows.

- **Establishment** in the target market (which may be subject, for example, to authorisation, or to recognition of professional qualifications, or to the use of certain legal forms, and may also be subject to discretionary powers).
- The use of **inputs** necessary to provide services (for example, there may be limitations on the extent to which the 'branch' can use the services of the personnel located normally in the 'parent' office in another country).
- The **promotion** of services may be made difficult (for example, by restrictive or detailed rules on commercial communications and advertising).
- The **distribution** of services across borders may be hampered (for example, by restrictions on the provision of services from the provider's home base together with authorisation, registration and declaration requirements).
- The actual **sale** of services across borders may encounter problems (arising from differences in, for example, contract law, price regulations and requirements relating to payment).

¹⁴ Report from the Commission to the Council and the European Parliament on the State of the Internal Market for Services', COM(2002) 441 final, Brussels, 30 July 2002.

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- **After-sales service** may face difficulties (relating, for example, to differences over professional liability and insurance, financial guarantees, or practicalities of services maintenance if they involve the movement of natural persons).

Having identified multiple barriers to trade, the Commission then made a sustained attempt to remove them, with detailed proposals based on the Sapir Report. These proposals, however, have not been adopted by the Council. It remains the case, therefore, that the European services market is only very partially regionalised.

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Table 12. Summary of relevant practice in a sample of customs unions

	EU	CARICOM	EAC	CACM	Mercosur
Creation of CU / members	Agreed in 1957 (Treaty of Rome); complete elimination of customs duties in 1968.	1993 (supposed to be fully implemented in 1998) – in 2007 implemented by all but two countries	2005 (to be fully implemented by 2010) Applied customs tariffs, rules of origin, import prohibitions, and trade remedy regulations have been harmonised.	Central American Common Market; 1960 (fully implemented 1965): Members: Guatemala, El Salvador, Honduras Nicaragua (Costa Rica – does not take part in CET)	Fully implemented in 1995 (with few exceptions)
CET	Introduced in 1968. CET rates have frequently been adjusted, either unilaterally (by a decision of the Council) or through negotiations between the Community and individual non-member countries or other international organisations, especially within the framework of GATT. Common customs tariffs are laid down in a basic regulation to which an annex is appended containing the actual duties as well as the tariff classifications. This annex is revised annually. In 2006, the EC Combined Nomenclature contained 9,843 lines, of which all are bound at WTO. The EC applies several types of tariff; ad valorem rates are the most widely used (90 percent), followed by specific rates (6.4 percent).	Ceiling of 35 percent lowered in stages (1993-98) to 20 percent: in 1995-96 to 30 percent; 1997 to 25 percent; 1998 to 20 percent.	The EAC tariff is based on the 2002 version of the Harmonised Commodity and Coding System (HS). Tariffs are applied on the c.i.f. value of imports at the point of entry to the customs union. CET has three bands (0, 10 percent, and 25 percent); rates above 25 percent apply to a number of 'sensitive' products (dairy, wheat, sugar). CET maximum rate to be reviewed in 2010.	Common customs code since creation of CACM; modernised in 2000: operates according to the third version of the Harmonised Commodity Description and Coding System. 2006: unified tariffs on 94.6 percent of headings encompassing 5,846 products of the Central American Tariff System. Virtually all intraregional tariffs are eliminated since the 1990s and the CET covers 95 percent of all imports, with an average rate of less than 5 percent.	In 2006 the simple average MFN tariff was 10.4 percent, having fallen from its 13.8 percent level in 1998. CET rates can only be modified with the consent of all members. About 80 percent of member countries' trade is subject to the CET.
Free trade / freedom of transit	Tariffs and quotas were officially abolished in 1958. However, the last physical, technical and tax-related barriers to free movement dismantled in 1993.	Largely. Freedom of transit exists since the inception of CARICOM. Goods imported or exported between members will only incur charges in respect of services. However, NTBs constrain intra-regional trade.	Not yet. Trade between Tanzania and Uganda as well as imports from Tanzania and Uganda to Kenya, has been duty free since 2005, while goods from Kenya to Tanzania and Uganda either a) immediate duty-free; or b) subject to a gradual tariff reduction: tariffs remain on 880 lines at HS6 for Tanzania and 443 lines for Uganda to be gradually phased out by 2010.	Yes (except coffee and sugar cane). Regulations on the International Customs Transit Regime contain provisions concerning international transit operations applicable to goods originating in or from member countries as well as third countries.	Yes (except automobiles and sugar)

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	EU	CARICOM	EAC	CACM	Mercosur
Legislation on value of goods	<p>From the beginning a high priority given to the harmonisation of customs legislation because of the need to ensure equal treatment through the uniform application of the CET. Action programme in 1963 to apply binding rules on the enactment of directives and regulations. Directives agreed on outward processing arrangements (1975); on goods returned to the Community's CU (1976); on deferred payment of duties (1978) and the remission of import and export duties (1979) were needed to complete the CU. Harmonisation was crucial for the Community's integration process in the 1960s. The legal framework of harmonisation includes the approximation of members' laws to the extent it affects the proper functioning of the common market (such as customs legislation).</p>		<p>The EAC members have introduced or are in the process of formulating legislation that will bring their trade regimes more up to date and into greater conformity with WTO regulations.</p>	<p>The Central American Uniform Customs Code and its regulation aim to establish basic customs legislation (based on the 1994 GATT Customs Valuation Code); however not all countries have done so and national laws adopt very different approaches regarding minimum values, bookings and extensions.</p>	<p>In December 2004 an agreement on elimination of double charging of the CET and distribution of customs revenue within MERCOSUR in order to develop the customs union was agreed and implemented from January 2006 on. Further measures are set to be agreed upon 'by 2008 at the latest': a single MERCOSUR customs document, an Understanding on the distribution of customs revenue, and the establishment of the Regional Registers Database of Offenders (RIM); also by this date the computerised customs management systems are to be interconnected.</p>
Customs control	<p>Customs controls were only finally abolished with the completion of the Single European Market (1993).</p>	<p>Cooperation between customs administrations was set up with the creation of CARICOM to ensure harmonised compliance regarding regulations, rules of origin, customs duties, export drawbacks and internal taxation.</p>	<p>Agreement exists on common customs procedures and valuations but in practice customs procedures have not been fully harmonised by EAC members. Customs valuation is based on the transaction value as provided for by the WTO Agreement on Implementation of Article VII of GATT 1994.</p>	<p>2001: Integrated customs controls were put in place. 2002: five juxtaposed customs services and four peripheral juxtaposed customs service were in place. Tasks: raising tax revenue and inspecting goods. Additionally, a number of customs facilities were in the process of being set up. Mutual recognition of safety inspection records for manufactured goods and adoption of standardised customs procedures (2002). 2004: customs facilitation: 1. one stop (joint window between two countries) to reduce time for migratory and customs operations; 2. electronic transmission of the Central American Uniform Customs Form for intra-regional operations</p>	<p>A Subdirectorato-General of Customs Control has been created to modernise customs control. Procedure most frequently used in practice is direct customs clearance.</p>

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	EU	CARICOM	EAC	CACM	Mercosur
SDT / infant industry protection	No SDT; but sectoral policies and common funds to equalise development in the Community.	Yes Special arrangements for Eastern Caribbean countries in terms of tariff reduction (eliminated in 2001), revenues, internal taxation, rules of origin, fiscal incentives and temporary infant industry protection. Implementation of Regional Development Fund is outstanding (agreed in 2006).	Yes (but time restricted to 2010)		Argentina applied tariffs to protect its industries from the recession in 2001 and raised the tariff to 35 percent on numerous consumer goods. This policy was partially reversed following the peso devaluation, and the tariff increases were phased out in December 2003.
Exceptions from CET	None.	No real 'common tariff': broad scope for tariff suspensions and reductions as well as for national derogations from the CET	Tariffs remain in place on exports of 880 items from Kenya to Tanzania, and 443 items from Kenya to Uganda, and are to be phased out by 2010.	In 2006, 5.4 percent of products were not subject to harmonised tariffs, mainly agricultural products	Sector-specific exceptions (for capital, informatics, telecommunication, automotives and sugar) should have merged in 2001 but deadline was not met. Result: exception lists of 100 tariff lines and concessionary regimes to individual members allowed until Dec 2008. CET can be temporarily reduced in case of insufficient intra-regional supply. Extra trade regimes for automotives and sugar. A common sugar regime has been under negotiation since 2006. For the time being MFN with a 20 percent preference for intra-regional trade is applied.
Other duties and charges and NTBs	VAT and excise duties are set at national level; Research in the period 1982-2004 confirmed that NTBs still exist and vary considerably across countries and sectors. NTBs have a higher incidence in scale intensive and science based sectors, instead of more traditional sectors. ¹⁵	Unauthorised NTBs are still a problems (such as environmental levies, consumptions taxes and consent fees)	Possible by individual countries; internal duty and tax exemptions have not yet been harmonised. Progress on dismantling of NTBs on intra-EAC trade has been slow; regulations on import prohibitions have been harmonised	60 barriers identified in 2002 were eliminated in 2005.	

¹⁵ Non-Tariff Measures in Intra-EU Trade: Sectoral and Country Incidence (ec.europa.eu/education/programmes/ajm/organisation/globalised_world/contributions/contribution-guimaraes.pdf)

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	EU	CARICOM	EAC	CACM	Mercosur
Safeguards and anti-dumping	Abolished with the Treaty of Rome (1957)	Explicitly allowed in the revised Protocol signed in 2000.	Provisions on contingency measures exist; safeguard measures can be applied until 2009; countervailing measures to offset the effects of subsidies can be applied.		Intra-regional safeguard measures from 1991-96 in case of emergency, after consultation of the Common Market Group and for a max. of one year. Regulations on safeguards were extended up to 2000 and then abolished. Thereafter, common legislation on safeguards based on WTO. WTO Agreement on ADS has been applied but additional contingency measures exist (which are to be gradually eliminated).
Technical regulations, standards, SPS, rules of origin	Existing obstacles of TBT were evaluated in 1962. Common directives were agreed on foodstuff (1962); pharmaceuticals (1965); meat, seeds and plants (1966); motor vehicles (1970); tractors (1974). In certain areas not fully harmonised compliance is established by conformity assessment procedures. EU standardisation bodies develop harmonised standards. Common legislation on SPS.	National Standards Bodies have been established in 11 member states. CARICOM Regional Organisation for Standards and Quality (CRQSQ) has been adopted by 6 countries so far.	Harmonisation of standards (566 joint standards were adopted in 2005). EAC will formulate common mechanism to identify and monitor the removal of NTBs (incl. standards and technical requirements). Common rules of origin. Criterion of substantial transformation is satisfied if the imported content of the goods is no more than 60 percent of the c.i.f. value of the cost of materials and the value-added accounts for at least 35 percent of the ex-factory cost of the goods (change in tariff heading).	2006: 97 percent of the rules of origin were standardised. Working towards harmonised technical standardisation, metrology, SPS and authorisation procedures. A standard SPS transit instrument is in process.	For intra-MERCOSUR trade, rules of origin may be either general or specific. General: products must be wholly obtained/ manufactured in Mercosur; where materials from third countries are used, either a change in the tariff heading must take place or the f.o.b. value of the final product must not contain more than 40 percent of inputs from third countries (c.i.f. value). Special rules: apply to chemicals, agrochemicals, steel, capital goods, telecommunications and computer equipment, dairy products, paper, textiles and footwear. TBT Committee on Mercosur technical regulations and standards. Mercosur technical standards are endorsed by a working group on technical regulations and conformity assessment for areas such as food, toys, electrical products, automotive industry, metrology, and conformity assessment. Separate working subgroups on issues such as telecommunications and health develop technical requirements for their respective sectors. Common standards have been developed and members also aim to harmonise standards.

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	EU	CARICOM	EAC	CACM	Mercosur
Export assistance/investment incentives	Common policies were developed and are applied.	2005: Member countries began work on a common investment code and harmonised investment incentives (technical work on a regional investment code and harmonised regional investment incentives has been completed)	Not yet fully harmonised. Individual EPZ, duty drawback schemes etc. are allowed		Not harmonised yet. Countries apply individual tax incentives and investment schemes.
Regional competition policy	Since 1962 policy is in the hands of the Commission which has supranational power, and can act largely without reference to the Council of Ministers and without the need to achieve consensus among members. Common competition rules are directed against private companies and governments. The final decision on the Community's competition policy is with the European Court of Justice. National competition laws exist but European law takes precedence over national law.	Not yet. Only two countries have national competition bills; a Regional Competition Policy has been established but is not yet operationalised.	Not yet. Kenya and Tanzania apply national competition laws; Uganda is drafting a national law. An EAC Competition Bill is under consideration.		Not yet. National competition laws exist. On a regional level a competition law was approved in 2002 but had not (at May 2006) been ratified by all members.
Common trade policy	Yes for goods - European Commission has sole authority to negotiate on basis of a mandate approved by Council. Other areas of trade policy are a shared Union-National responsibility.	Partly. CRNM coordinates external negotiation on bilateral and multilateral level	No.		Yes: the Trade Commission is responsible for the application of common trade policy instruments
Common institutions	The Commission and the Council of Ministers are mainly involved in policy-making playing – and follow-up largely divergent interests (national vs. supranational decision making). The European Court of Justice takes precedence over national courts in areas of Union competence. The European Investment Bank operates alongside national development finance institutions.	Heads of Gov and Secretariat form the Executive; Standing Committee of Ministers forms the Legislature. Supporting organs; Judiciary (but appellate jurisdiction still limited).	Heads of Gov and Secretariat form the Executive. The legislature comprises the Council of Ministers which initiates bills and gives directions to member states, supported by a Legislative Assembly that has a watchdog function and is ultimately responsible for the legislative process. A Coordination Committee is responsible for regional coordination/cooperation and the implementation of decisions. Sectoral Committees formulate programmes and monitor implementation. Court of Justice ensures that EAC law is implemented.		Six organs, of which three are intergovernmental with decision-making powers: 1. the Council of the Common Market (responsible for consolidating regional integration); 2. the Common Market Group (executive body responsible for supervising the implementation of the Treaty); 3. the MERCOSUR Trade Commission (responsible for implementing a common trade policy). The rulings of these bodies are binding on all member countries. The organs with no decision-making powers are: the Joint Parliamentary Commission, the Economic and Social Advisory Forum, and the

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	EU	CARICOM	EAC	CACM	Mercosur
					MERCOSUR Administrative Secretariat. None of the MERCOSUR organs is supranational; they are all intergovernmental.
Common Dispute Settlement / Outstanding institutions	European Court of Justice deals with all disputes regarding the 'acquis'. Its decision is binding on all member states.	Partly. The Caribbean Court of Justice (CCJ) acts as the original jurisdiction for settlement of disputes on the functioning of the CU. The aim is for the CCJ to become an international tribunal with compulsory and exclusive jurisdiction for the interpretation and application of CARICOM regulations, settling any dispute. Many member states, however, continue to utilise the Privy Council in London as their final appellate. As of 2005 the court's appellate jurisdiction is limited to Barbados and Guyana.	There is: a Court of Justice in Arusha; a Committee on Trade Remedies (to deal with anti-dumping and safeguards); an EAC Competition Committee.	Yes. Applies to the prevention or settlement of all disputes regarding the implementation or interpretation of economic integration instruments.	Yes. In 2004 the Brasilia Protocol has been replaced by the Protocol of Olivos, which incorporates a stage for reviewing the arbitration awards made by MERCOSUR's ad hoc arbitration tribunals that is restricted to points of law and legal interpretation. It also includes a clause offering a choice of competent forum (MERCOSUR, WTO, or other preferential schemes). The dispute settlement regime is actively used by member countries.
Distributional policies	The foundation treaty did not include an agreement on resource distribution but wanted to achieve equivalent development by different strands of common policies (e.g. the CAP). However, in 1958 the European Social Fund and EIB were founded mainly to assist Italy. Additionally, limited funds for 'structural measures' were made available. With the first enlargement in the early 1970s it became clear that richer member countries would have to finance regional integration (since the EC is financed by its 'own resources'). In 1975 the European Regional Development Fund was set up. However, it was never substantially financed and EU spending was concentrated on the CAP.	Development Fund was established in 2006 (but has not yet been implemented) to underscore that SDT should not be limited only to trade provisions but must also incorporate financial provisions. The Fund will seek to provide financial or technical support through loans, grants and interest subsidies. Common support measures are envisaged (but have not yet progressed) with respect to human resource development, research and development, environmental protection, social infrastructure, and the role of public authorities.			

SECTION D: OPTIONS FOR REVENUE COLLECTION AND ALLOCATION

1. Borders and revenue

A customs union consists of a group of countries that levy a common external tariff on trade with the rest of the world and, as explained in Section B, normally has no import tariffs on trade among its own members. In a fully implemented CU it is unnecessary to have internal border controls for customs duty purposes or to design and implement cumbersome and costly rules of origin that are necessary in a preferential trading area in which members have different external tariff structures.

One way to ensure that imported goods move freely within the CU is for import duties to be collected at the initial port of entry into the CU. Unless imports can be identified according to their final destination within the CU this means that tariff revenues will tend to accrue to the countries where the goods first clear customs rather than to the countries of ultimate consumption (if these are different). This might be acceptable to all members if a) customs duties are an unimportant source of revenue for most governments, and/or b) customs revenues are deemed to be community property of the CU and are used for collectively determined community purposes and/or c) if trade flows are sufficiently symmetrical that any member's losses are offset by the gains they make when goods imported into their territory (for which they collect the tariff) are consumed in a neighbour.

An alternative to collection of duties at the first port of entry is for goods to be shipped in bond to the ultimate destination and for duties to be collected at that point. Such an arrangement will be costly, in terms of the logistical costs of running transit and bonding facilities, and will also diminish many of the expected gains from entering a Customs Union. These include the significant gains arising from the entrepôt functions performed in key logistical hubs and from the processing of raw materials and generation of retail and wholesale services in intermediate locations before arrival at the final destination.

Given the significance of tariff revenue for most SADC countries, the method for collecting and then allocating customs duties within the customs union will therefore be a major issue. These concerns are echoed by Viner (1950) in his classic work on customs unions:

The greater the disparity in economic levels between the members, and the greater the differences as between the members in the customary consumptions of imported commodities, the greater is likely to be the difficulty in finding a formula for allocation of customs receipts which will be mutually acceptable.

The wide variations in income and economic structures within SADC along with the varying levels of dependence on trade taxation all point to the importance of a SADC customs union agreeing a simple and transparent arrangement for revenue collection and allocation. The various ways in which this is done elsewhere and might be achieved in SADC, are explored further below.

2. Key features of other Customs Unions

A major initial question that arises in the formation of a customs union is whether the customs revenues collected are to be treated as community property or as income accruing to each of the member states.

If one of the main objectives of the customs union is to facilitate a coordinated reduction in internal and external trade barriers and facilitate the regions integration into the global economy, then the formation of the union will deliberately lead to a reduction in overall reliance on customs duties as a revenue source. In that case, a significant share of revenue collections might end up

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being allocated to the joint administration of the customs tariff. Even if the tariff continues to be a significant revenue source, the union still might decide to treat all or part of these revenues as a pool to be used for common development purposes.

The EU is the only existing Customs Union to have implemented this model. See Table 13 below.

All other customs unions continue to treat customs revenues as the property of individual member states and there are several possible principles upon which to base their allocation. These generally fall into three basic categories which are not necessarily mutually exclusive.

They include:

Allocation according to the place of consumption (i.e. destination principle)

Almost all customs unions (seven out of the nine reviewed in this study) allocate revenues according to the destination principle. This usually requires that imports remain in bond until they reach the country of ultimate consumption, where the tariff is paid. But this only covers whole consignments all of which are consumed in a given country. Specifically, it does not cover imported inputs that are transformed in one country and consumed in another. To ensure that member countries do not collect revenues on imports which are then 'transformed' for the sole purpose of exporting duty-free elsewhere in the CU, may require rules of origin and substantial internal border controls within the CU. There is some risk that peripheral or land-locked countries will lose some revenues as a result of fraud and leakages; or that the cost of administering such as system might outweigh the economic gains from integration.

Allocation based on the point of first entry

Although no existing customs union allocates all revenues on the basis of where imports first enter the union, the EU does permit member states to retain 10% of their own collections. If all trade taxes are collected at the point of first entry and administered centrally, then member countries do not need to monitor the passage across their borders of goods originating outside the CU. This greatly reduces transaction costs at internal borders and maximises the economic gains from the union. But it requires both a high level of trust and appropriate institutions, both of which will tend to become harder to achieve the greater the number (and more disparate) the members.

Allocation based on some pre-agreed formula or percentage

A variation of the above option is the possibility that all trade taxes are collected upon first entry into the union and then shared among all member states according to a revenue sharing formula. The agreed formula could provide for a simple reallocation based on negotiated and fixed shares, or it could involve a more complex range of economic and demographic variables. See the discussion on SACU below for a description of some of the problems that can arise from a complex revenue sharing arrangement.

In addition to and within each of these three broad options, it is still necessary to establish common institutions to administer the union and to possibly provide financial or technical support to poorer member countries. These institutions can be funded out of common revenues (as in the EU) or out of direct contributions from member states (UEMOA/WAEMU provides for an additional tax of 1% on imports).

3. The SACU Revenue Sharing Arrangement

The new SACU revenue sharing formula (RSF) was implemented for the first time in 2005. The formula was intended to improve revenue stability for the BLNS and provide implicit compensation for the 'cost-raising' and 'polarization' effects of the customs union (Kirk and Stern,

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2003). In practice, it has caused increasing instability and friction within SACU and introduced a number of additional distortions to trade and economic relations between its member states.

3.1. Key features of the revenue sharing formula

The SACU revenue sharing formula is unique in a number of ways. Firstly, it includes excise duties in the common pool and common excise rates are applied throughout the customs union. Secondly, all customs and excise duties are pooled and distributed according to a formula which largely disregards the source of taxation or destination of the underlying trade. Finally, it provides for a large amount of implicit compensation from South Africa, as the dominant economy in the region, to the BLNS.

The revenue sharing formula deals with customs and excise duties separately and allows for the creation of a distinct development component. These three 'components' are shared as follows:

- *Excise component:* 85% of excise collections are distributed according to members' GDP.
- *Development component:* The remaining 15% of excise collections are distributed in near equal shares (20 percent), adjusted marginally in favour of the lesser-developed member states.
- *Customs component:* Customs duty collections are distributed according to members' shares of intra-SACU trade.

Table 13 (from Flatters and Stern, 2006) shows the current distribution of revenues under the revenue sharing formula, together with some indicators of the importance of these revenues in each of the SACU Member States. Whereas South Africa receives most of its share through the excise component, Lesotho, Namibia and Swaziland are highly dependent on customs duties for a large share of total government revenue.

Table 13. Receipts from SACU Revenue Pool, 2006

	Excise	Devel'mt R million	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
South Africa	13512	493	3620	17625	1.0	3.9	666

Source: Flatters and Stern (2006).

3.2. Problems arising from the new SACU Agreement

Flatters and Stern review the main data and economic problems arising from the implementation of the new SACU Revenue Sharing Agreement. These are:

- *Questionable Trade Data.* Implementation of the customs component of the revenue sharing formula requires clear definitions of and data on intra-SACU trade. There is no authoritative, consistent and mutually agreed source of intra-SACU trade data and no mutually agreed definition of what is meant by intra-SACU trade.
- *Disagreement over the Costs and Benefits of SACU.* There remain stark differences in opinion about and perceptions of the economic costs and benefits of SACU and how SACU payments should be treated in the national accounts of member countries. Whereas South Africa portrays "excess" payments to the BLNS as 'transfers' or development assistance, the BLNS maintain that SACU payments are fair compensation and should be treated as 'own revenues'.
- *The Volatility of the Customs Pool.* The customs pool and SACU payments are highly sensitive to changes in imports, tariffs and the exchange rate. They are particularly sensitive

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to trade in motor vehicles, with car imports contributing around 40% of total customs collections. Revenue has risen sharply over the last few years but could fall equally fast in response to changing demand conditions in South Africa.

- *The Predictability of Payments.* The BLNS members rely on the customs pool for a large share of their fiscal revenues. Intra-SACU imports are difficult to predict on an annual basis, and they are likely to be subject to large year-to-year variability. This makes budget planning difficult.
- *Fundamental Source of Conflict.* The division of the customs pool is a 'zero sum game' in which any player's gain comes at the expense of all the other players. This is made worse by ambiguities and uncertainties in the data used to share the customs component.
- *Customs and Trade Facilitation.* By basing the division of external customs duties on the value of intra-SACU trade, there is an additional need for border controls and documentation. This will raise rather than diminish internal barriers to trade.
- *Perverse Incentives for Trade Policy.* Because the BLNS receive most of the duties paid on their own and South Africa's imports, they have a strong economic and financial interest in maintaining and maybe even increasing import tariffs. This will make it difficult for SACU to engage in serious tariff reform.
- *Perverse Incentives for expansion.* The formula discourages existing members from extending membership to a country to whom they export a lot (i.e. whose intra-SACU imports are higher). They are also likely to resist ways to increase imports from new members.

3.3. Lessons from SACU for SADC

Implementation of the SACU revenue sharing formula has revealed a number of opportunities and problems from which SADC can learn. Firstly, on a positive note, the existence of a revenue sharing arrangement encourages the free movement of trade within SACU and reduces logistical costs substantially. Almost all imports enter the region through South Africa and the South African Revenue Service collects the bulk of SACU customs and excise duties, regardless of final destination.

Unfortunately, the design of the new formula undermines many of the gains from trade facilitation that the customs union is supposed to promote. The need for detailed and accurate data on intra-SACU imports raises internal barriers to trade; and the use of the customs pool to provide implicit compensation to the BLNS raises their dependence on volatile trade taxes substantially.

For these reasons, the SACU revenue sharing formula is not a good model for SADC and in fact, current developments in SADC provide additional reasons for the reform of SACU regardless of what SADC decides. Furthermore, the SACU experience suggests that any form of redistribution or development assistance should be unbundled from customs collections. Ideally, customs duties should be shared on the basis of the underlying trade and a separate development budget agreed (even if funded by customs collections). Finally, data collection and accuracy are paramount in the design of any form of revenue sharing or distribution arrangement and need to be carefully considered up-front.

4. Key principles for revenue sharing

4.1. Economic Principles

Forming a customs union among countries that are previously independent for customs purposes or that have already established an FTA among themselves does not necessarily require any changes to the **procedure** for collecting of customs duties. In most cases, duties are collected on a destination basis before and after the establishment of a customs union. But the removal of barriers to internal trade can still have serious revenue effects.

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Within the customs union there are generally transit facilities to allow for the good to travel duty free through to the country of final destination. Some customs unions allow for members to establish customs facilities in the territory of other member states in order to collect the customs due to them at the first point of entry. So in practice, duties paid on imports from the rest of the world could still be collected by the country of final destination. But with the formation of the customs union and the dismantling of internal barriers, it becomes increasingly difficult to track goods that are often transformed, repackaged or otherwise modified as they move from one country into the territory of another. Moreover, the eradication of rules of origin raises prospects for trade diversion.

Thus, even under the destination principle, there can be real losses in revenue for some member states and in particular, there is likely to be some diversion in collections (or economic activity) away from land-locked and less developed countries and towards the more developed trading hubs in the region.

Significant exceptions to the destination principle include the European Union (Box 1) and the Southern African Customs Union (SACU). In the case of the EU, the abandoning of the destination principle arose from a decision to treat customs revenues as the collective property of the union (aside from the amount set aside as payment for customs services provided by the collecting country). In the case of SACU, almost all duties are collected upon entry into South Africa as the dominant economy and trading hub of the union and it is therefore necessary to redistribute collections among the other member states.

Thus, regardless of how revenues are collected, the removal of internal border controls is likely to lead to a change in the allocation of customs collections between member states. These adjustments are likely to be more stark in the case of a custom union where revenue are collected at the first point of entry, but could be equally severe under the destination principle, and especially in the case of customs unions which involve a combination of coastal and landlocked countries and economies of differing size and structures.

SACU deals with this 'problem' by providing implicit compensation from South Africa to the BLNS for the so-called 'cost-raising' and 'polarization' effects of SACU. What justification, if any, is there for providing economic compensation within SADC to the least developed and land-locked members of the Customs Union.

Compensation for revenue loss due to adoption of a lower import duty

A common argument in discussions of FTA- or CU-based tariff reform is the need for compensation of members for consequent revenue losses. Revenue losses can arise as a direct effect of adopting a different tariff structure and in particular as a result of agreeing to apply no import tariffs to intra-group trade, and as an indirect effect of changes in traded patterns resulting from moving to an FTA or CU. The first type of effect is generally larger and can be referred to as first order effects of a CU. The indirect effects are generally small and can be thought of as second order effects. As will be seen further below, existing tariff structures in SADC differ widely, with the trade-weighted average tariff rate of Member States ranging from under 3 to over 21 percent at present. Under a destination-based revenue allocation formula, the direct revenue impact of adopting a CET with an average rate of 10 percent would be a substantial gain for some members (all those with an average rate of less than 10 percent) and revenue loss for others. Whether the overall revenue gains would be greater or less than the overall losses would depend on whether aggregate revenue collections increase or fall with a 10 percent common tariff.

Suppose that aggregate revenues are unchanged. Would there be justification for a scheme in which the revenue "winners" compensated the revenue "losers?" There is no *a priori* presumption in favor of such a scheme. This is because the revenue losses in the "losing" members would be (more than) offset by welfare gains by users of imported goods in the same countries as a result of reductions in average import duty rates. Joining the CU results in a transfer from government

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revenues to users of imported goods in member states that suffer government revenue losses. In the revenue-gaining members, the opposite is the case. The revenue gains are (more than) offset by welfare losses by users of imported goods in these countries, as a result of being burdened by higher import duty rates.

In this case, there is no *a priori* justification for redistribution to (or compensation of) revenue “losers”; in fact the argument is the reverse—any compensation should be in favour of the countries that are now faced with higher tariff burdens (and revenues) as a result of the CU and paid for by those that benefit from a reduction in the burdens of protection as a result of the CU. But the required redistribution is much smaller, in fact of a completely different order of magnitude, than indicated by calculations of revenue gains or losses.

What if the CET is lower than the average for all of SADC? In this case there will be greater revenue losses than revenue gains, and there would be no way for any gainers to compensate the losers, even if it were decided this would be a good thing. But once again there would be no economic justification for compensation, since there would have been a net improvement in overall welfare within the union, with the only losers (now a smaller group than in the previous example) being those countries that have had to face higher import duty rates as part of the deal to join the CU.

Compensation for Trade Diversion Impacts of the CU

In the case of preferential trade liberalization, there may be additional revenue losses due to trade diversion—i.e. in the case of a SADC CU, tariff preferences on intra-SADC trade may encourage importers to switch from low-cost international suppliers to higher cost SADC sellers. This might be a more serious danger in some of the smaller, less developed member states. However, it must be noted that the proposed SADC CU is part of an evolution from a pre-existing FTA in which at least some of any potential trade diversion will already have occurred, and certainly would eventually occur even in the absence of a CU. Of greater importance, however, is the level and structure of the CU's CET. A structure of high rates, especially on goods produced by predominantly import substitution industries in one or two member countries would substantially increase the dangers and costs of trade diversion in a SADC CU. If, on the other hand, formation of the CU is used as an opportunity to rationalize the overall external tariff structure, and increase the integration of the region in the global economy, the amount and costs of trade diversion would be reduced.

To the extent that there are revenue losses due to trade diversion, there is a net economic cost. However, the economic cost is not the total amount of the revenue loss. Rather, it is only the difference between this revenue loss and the higher cost of SADC-sourced imports compared with what they would have cost if bought from the lowest cost source. The revenue loss is an upward-biased estimate of the loss from trade diversion. The size of this bias is larger the smaller is the CET on the diverted goods.

Compensation for “cost-raising” impact of the tariff

It is sometimes argued that poorer and/or less industrialized CU members suffer a “cost-raising” impact of a common tariff designed to protect industries in some of the more developed members. While this may be true, it is important to note the links between the cost-raising and revenue impacts of the CET associated with a CU.

If the agreed CET has the same average rate as a member's pre-CU external tariff, there will be no net revenue impact of the CU. By the same token, with the same average rate of tariff there will be no net cost raising impact of the tariff, at least on average. (But note the possibility of a different rate structure leading to cost-raising for some goods and cost-reducing for others.)

If the CET is higher, on average, than a member's pre-CU external tariff, there will be a cost-raising and also an offsetting revenue-raising impact, i.e. in the absence of any other tax system adjustments, there will be a net transfer of income from users of imported goods to the government. Due to the net economic costs of adopting a higher tariff, the cost-raising impact will

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exceed the revenue raising effect. But this net effect is much smaller than the gross cost raising impact of the tariff as commonly measured.

Similarly, if the CET is lower than a member's pre-CU external tariff, there will be a "cost-reducing" impact and an almost corresponding and opposite revenue reducing effect—i.e. a transfer from government to users of imported goods—with the gains to users of imports larger than the cost to government revenues, but with the overall net gain much smaller than what would be measured by gross cost reductions.

As this discussion indicates, it is economically inconsistent for members to argue for compensation for both revenue losses and cost raising impacts of a CU's CET.

4.2. Administrative principles

Eliminating tax in intra-customs union trade is cited as one of the major justifications for a customs union. In principle this can also be obtained from a free trade area, however, the existence of a common external tariff enables the union to dispense with rules of origin, reduce border related formalities, lower business costs and promote increased competitiveness.

However, in customs unions between sovereign states the border performs many functions in addition to levying customs duty. These include policing the movement of persons, checking for the transmission of illegal and regulated products, ensuring compliance with domestic standard and health and safety requirements and also for levying non-discriminatory indirect taxes (such as Excise and Value Added Tax). Prior to the establishment of the internal market in the European Union the cost of border related formalities were estimated at approximately 2 per cent of the value of intra-community trade.

The establishment of a customs union will deal with on set of border frictions and costs, but might raise many more. For example, removing customs controls on intra-union trade may, in the absence of harmonizing standards and indirect taxes, create an incentive for illegal trade and fraud. This in turn might force the larger economies to impose new kinds of non-tariff related controls and restrictions on internal trade.

Border harmonization therefore needs to go beyond the elimination of intra-union tariffs for SADC to reap the full benefits of a customs union. Improved customs capacity and cooperation is equally if not more important. The modeling analysis looks specifically at the benefits from removing internal tariffs and from wider border reforms.

4.3. Political principles

In signing-up to a Customs Union member countries agree to surrender political autonomy over trade policy and adopt a common external tariff. In principle, this loss applies to all member countries and is more than compensated for by the economic gains from accessing a larger internal market and, more importantly, increasing the extent and effectiveness of the region's integration with the global economy. While some may the devolution of responsibility for external trade reform to a neutral and independent authority as a political cost, the protection of a country's broader economic interests against self-promotion by narrow special interests is generally regarded as one of the benefits of international trade agreements, regional and global.

This assumes that no member country imposes its own trade policy or tariff structure on that of the union and that the Customs Union provides a platform for more general internal and external liberalization in the interest of all member states.

A very different situation might arise if the SACU external tariff is extended to the rest of SADC. The SACU CET is extremely complex and has been explicitly designed to reflect the industrial

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structure and policy priorities of South Africa¹⁶. In this case, there may be grounds for establishing a contribution-based development fund to compensate other member countries for adopting a tariff structure that is not inherently in their own economic interest (note that a development fund might have a justification that is quite different from and independent of any economic arguments for compensation.)

5. Revenue Options for SADC

The international experience and the principles described above lead to a limited number of options for collecting revenues and a number of alternative methods for allocating these collections to member states. The main decisions to be made by SADC are a choice between a) collection on arrival or at destination and b) with or without subsequent changes in “ownership” of the revenues. Changes in ownership can come about, in turn, through a fund (community ownership) or through a formula. The various options resulting from these choices are summarised in Table 14 below.

To reduce internal border frictions and maximize the economic gains from regional integration requires a move from away from the commonly used ‘destination principle’ to one where all revenues are collected and kept at the first point of entry into the customs union. For this approach to work for all SADC member states, will require the development of a revenue sharing mechanism or common fund.

Experience would caution against tying the source of the formula or fund to trade taxes, as this would create an incentive for the major beneficiaries to limit further tariff liberalization. Further, experience from other regions would caution against establishing the fund or formula as a ‘Compensation Facility’. Regional disparities represent a long-term challenge and should not be perceived as a short-term adjustment issue.

If a decision is made to proceed according to options C or D below, careful consideration will need to be given to clearly defining the objectives of the formula or fund and specifying the funding, administrative and allocation criteria. The main lesson from SACU is that this can be a long, controversial and difficult process.

¹⁶ It may also encounter problems with the WTO Art 24 requirement that the new CET is not higher across-the-board than that of many members.

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Table 14: Evaluating the Options for Revenue Collection and Distribution

Option	Collection		Ownership		Allocation		Evaluation
	Destination	Arrival	Change	No Change	Fund	Formula	
A	X			X			A pure destination-based allocation of the tariff revenue is unlikely to be acceptable within SADC given existing disparities of income and differences in economic development and geography. In practice, a few countries would collect and keep most of the customs duties on imports into the region regardless of the final destination; and these same countries would probably benefit most (or lose the least) from the effects of trade diversion. Moreover, the proper implementation of this approach would require strict bond processes and possibly even rules of origin within the customs union, thereby raising internal border frictions.
B		X		X			Moving to an approach where revenues are retained at the point of first entry in the CU would greatly diminish the administrative costs associated with the destination principle and from a customs perspective ¹⁷ , would enable the free movement of domestically produced and imported goods between member states. But this approach might have serious revenue implications for land-locked or peripheral SADC member states, many of which are highly dependent on customs duties as a source of government revenue. A small number of countries currently serve as the trade hubs of the region and these countries would expect to collect most regional import duties under conditions of free internal trade. How much additional revenue loss there might be relative to the full implementation of the SADC FTA to which all members are already committed is, of course, an open question.
C		X	X		X		Under this option each country would retain customs receipts at the point of first entry into the CU based on its imports from the rest of the world. In addition the customs union would establish a Regional Fund to which all members would contribute and would also be eligible to receive grants for development projects. Contributions to the Regional Fund would be related to the relative size and level of development of individual member states. The major objectives of the Fund might include, inter alia, promoting the development of lagging regions, addressing regions undergoing industrial or agricultural decline and to promote regional employment opportunities.
D		X	X			X	An alternative way of dealing with inequities arising from retaining customs duties at the point of first entry in to the customs union is through the application of a revenue sharing formula. Under this option, all or a proportion of total customs collections are pooled (or countries make independent contributions to a common pool) and then shared according to pre-agreed criteria or a range of economic variables.

¹⁷ For tax, security and standards reasons, there might be other reasons for maintaining controls on internal regional trade.

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Table 15: The allocation of customs revenues in selected existing customs unions¹⁸

	No. of members (of which LDCs)	Internal customs controls	Revenue sharing
Andean Community 1/	5 (1)	Yes	Destination basis, with collection on entry into country of final use.
CARICOM 2/	14 (0)		Destination basis, with collection on entry into country of final use.
CEMAC 3/	6 (5)	Yes	Destination basis, with collection on entry into country of final use.
EAC 4/	3 (3)	Retained for present, subject to review	Destination basis, with collection on entry into country of final use, until 2011, when issue to be reviewed.
EU	27 (0)	No	Revenue allocated to finance of union's activities, subject to retention of 25 percent by country of collection.
GCC 5/	6 (0)	Retained, but slated for removal (no date specified)	Destination basis, with collection at first point of entry into the union and revenues then reallocated to member of final use. (Importer required to identify country of final destination, and payment at that point then verified at entry into another union member).
MERCOSUR 6/	4 (0)	Yes	Destination basis, with collection on entry into country of final use.
SACU 7/	5 (1)	Yes (but largely for VAT purposes)	Customs duty generally paid at first point of entry into union, with revenue then reallocated to members in the same proportion as their share of intra- SACU imports (including re-exports).

¹⁸ Based on information provided by the IMF.

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UEMOA/WAEMU 8/	8 (8)	Yes	Destination basis, with collection on entry into country of final use. A one percent tariff (the <i>Prélèvement Communautaire de Solidarité</i> , PCS) is levied on all taxable imports, and the proceeds used to compensate some members (Mali, Niger, and Burkina Faso) for the revenue loss suffered as a consequence of the elimination of internal tariffs, and for other purposes (including mitigation of regional disparities and financing community institutions).
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Notes:

1/ The members are: Bolivia, Ecuador, Colombia, Peru and Venezuela. (Peru, however, does not apply the CET—to which there are some exceptions—and does yet fully participate in the free trade area formed by the others).

2/ (Caribbean Community and Common Market). Antigua and Barbuda, Bahamas (does not apply the CET), Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, St Kitts and Nevis, St. Lucia, St Vincent and the Grenadines, Suriname, Trinidad and Tobago.

3/ (Communauté économique et monétaire de l'Afrique centrale) (Cameroon, Congo Republic, Gabon, Guinée équatoriale, République centrafricaine and Tchad).

4/ (East African Community) Kenya, Uganda, Tanzania. Some imports from Kenya to Uganda and Tanzania are still subject to internal tariffs, gradually reduced over 5 years.

5/ (Gulf Cooperation Council). Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

6/ Argentina, Brazil, Paraguay, Uruguay

7/ (Southern Africa Customs Union). Botswana, Lesotho, Namibia, South Africa, Swaziland. The current agreement is reviewed by Flatters and Stern (2005) and Kirk and Stern (2003).

8/ (West African Economic and Monetary Union). Bénin, Burkina-Faso, Côte d'Ivoire, Guinée-Bissau, Mali, Niger, Sénégal and Togo.

Box 1: EU Revenue Policy

The European Union has structured its revenue collection policy to promote relative equity between the cost of administering the EU and the benefits received by each Member State. The revenue collection, program budgeting, and resource disbursement processes require approval from the EU Commission, Council and Parliament. The budgetary process is structured to ensure that expenses cannot exceed 1.24% of the GNI of the EU and that the EU never runs a budget deficit. Going forward the Commission anticipates connecting its revenue collection more directly to EU citizens.

The Own Resources system is used to provide the EU with revenue. Owned resources are divided into four categories each of which the EU agrees to deplete funding from before relying on the next.

- **Traditional Own Resources (TOR)** in the form of customs duties represent the original source of funding for administering EU policies and funding programs. Customs duties are considered the “most” natural revenue streams for administering the EU since they are collected based on EU policies rather than Member State national contributions. In addition levies on the production of sugar, isoglucose, and inulin syrup are charged to EU producers of these goods. The EU bases its customs valuations on the WTO Customs Valuations Agreements.
- **The Value Added Tax (VAT)** contribution was added as an additional EU revenue stream in 1970 when TOR were deemed insufficient to fund the EC budget. Each member’s VAT contribution is determined by applying a uniform rate to a calculated VAT base. Due to the lack of a harmonized VAT system, the VAT base is calculated using a notional system of dividing the total national VAT receipts of a Member State by the weighted average rate of VAT (determined by national macro-economic statistics). The base is capped at 50% of each member’s GNI to reduce the effect of VAT’s regressive nature. A uniform percentage or call rate not exceeding 0.5% is then levied on each states VAT base to determine their contributions.
- **Gross National Income (GNI)** based contributions were levied on member states beginning after 1988 and were meant to gradually replace the VAT contributions. This contribution is determined by applying a uniform rate in proportion to each Member State’s GNI. GNI contributions increasingly finance the bulk of EU administration expenses. As the final major type of funding to be accessed, GNI is also used to balance the budget, but total spending cannot exceed 1.24% of total EU GNI.
- **Other Revenue** provides a small portion of EU funds and includes tax on staff compensation; interest on assets/late payments, non-EU contributions to programs, and reimbursement of unused grants.

Financing trends: The EU has shifted the composition of Own Resources towards GNI for funding.

	<u>1996</u>	<u>2005</u>
GNI	29.6%	74.5%
VAT	51.3%	14.1%
TOR	19.1%	11.4%

SECTION E: REVENUE IMPACT ANALYSIS

1. Options for a Common External Tariff (CET)

Both Sections B and C refer to the fact that economic integration is expected to lead to increased welfare overall but that there will be distributional effects that will stimulate calls for action, some of which are more economically justifiable than others. The key empirical questions to feed into this discussion are how much welfare will increase, to which entities will the gains accrue (public or private), and where? The modeling seeks to answer these questions. A key determinant of the answers in any CU is the level at which the CET is set.

To evaluate the net revenue and economic effect of the proposed options, it is necessary to calculate the customs revenue likely to be collected under different CET options. Ideally, the CET options tested in this study should replicate those proposed by the consultants working on Study No.2; but the scheduling of the two projects makes this impossible. Instead, a spectrum of hypothetical CETs have been derived and applied throughout Study No.1. These are as follows:

- A uniform tariff of 10%;
- The current SACU CET;
- A staggered 3 level tariff; and
- A staggered 4 level tariff.

The selection and application of the 10% uniform tariff and SACU CET is relatively straightforward. The former represents the most simple tariff structure possible and has been set at a level likely to generate sufficient revenues for most SADC member states (current trade-weighted tariffs across SADC range between 5% to 15%); and the latter reflects the current trade and industrial policy regime of the region's largest economic block. Deciding on an appropriate three- and four-tier tariff to be used in this analysis was more difficult.

Given that it is beyond the scope of this study to develop a new CET for SADC we have restricted our choice to the existing tariff structures of all member states. See table 16 below for a summary of the main features of SADC members' tariff structures and Appendix A for a graphical representation of the frequency and level of individual country schedules. Two candidates stand out:

- *Mauritius* because its four-tier tariff schedule is the lowest in the region and therefore reflects the 'worst case' for other member countries from a narrow revenue perspective;
- *The DRC* because it has come closest to implementing a strict 3-tier tariff (there is just one 6-digit product line at 30%; all other tariffs are at 20%, 10% and 5%). By retaining a minimum duty on all imports, this schedule also ensures some revenue stability.

Table 16. Summary of SADC Country Tariff Structures

	Simple average	Trade weighted	No. of bands	% zero weighted	Peak
Angola	7.1	21.5	7	0.9	100
DRC	12.1	11.8	4	0	25
Madagascar	13.4	9.5	4	1.8	25
Malawi	13.4	12.1	7	8.6	30
Mauritius	3.4	2.6	5	84.2	30
Mozambique	12.2	10.3	5	2.2	20
Tanzania	12.9	14.4	10	35.9	30
Zambia	14.5	12.5	4	15.6	30
Zimbabwe	16.0	21.5	17	12.8	100
SACU	9.0	8.0 to 14.0	40	53.4	96

Source: Authors' calculations

2. The revenue impact

Estimating the revenue impacts of implementation of any CET requires assumptions about trade patterns before and application of the CET and about the tariff regimes that the CET will replace in each member state. Moving from any existing tariff structure to a CET will affect trade volumes and patterns as producers, consumers, traders and investors adjust to changes in the tariff regime. If the CET represents an overall reduction in tariff rates in any (or all) member states, it might be expected that overall trade will increase. Of special interest is whether additional freeing of intra-SADC trade as a result of the CU might lead to an increase in (duty-free) traded among members.

By the time of implementation of any SADC CU prevailing trade and tariff structures will almost certainly be much different than at present. This will be due to many factors, including

- General economic growth in all members, resulting in higher levels of imports,
- Possibly greater shares of intra-SADC imports in overall member imports as a result of more complete implementation of the existing Trade Protocol,
- Possible shifts in the geographic structures of, levels of and duty collections on members' imports as a result of preferential trading arrangements with third countries, especially EPAs, and
- Continued tariff liberalization in some or all member states as a result of unilateral reform (e.g. Mauritius) and WTO agreements.

This report takes none of these factors into account, but rather simply applies the four different CET options described above to the existing import profiles of SADC member states. This gives very rough estimates of the likely gross impact of a common CET on the customs duties collected by individual member states *under existing trade patterns and tariff structures*. This analysis is done at the six-digit HS code level and is therefore sensitive to the tariff level and value of imports at the product level, by country.

For the purposes of this study, we assume that the maximum duty applicable on all imports is collected and that the import profile of all member states remains static over time. The actual value of customs duties collected by member states currently, and under each of the four CET options, may differ substantially from the amounts calculated below. Figure 9 shows our estimates of the amount of duty collected on world imports at the MFN tariff against estimates of the actual amount of trade taxes collected derived from World Bank national account data.

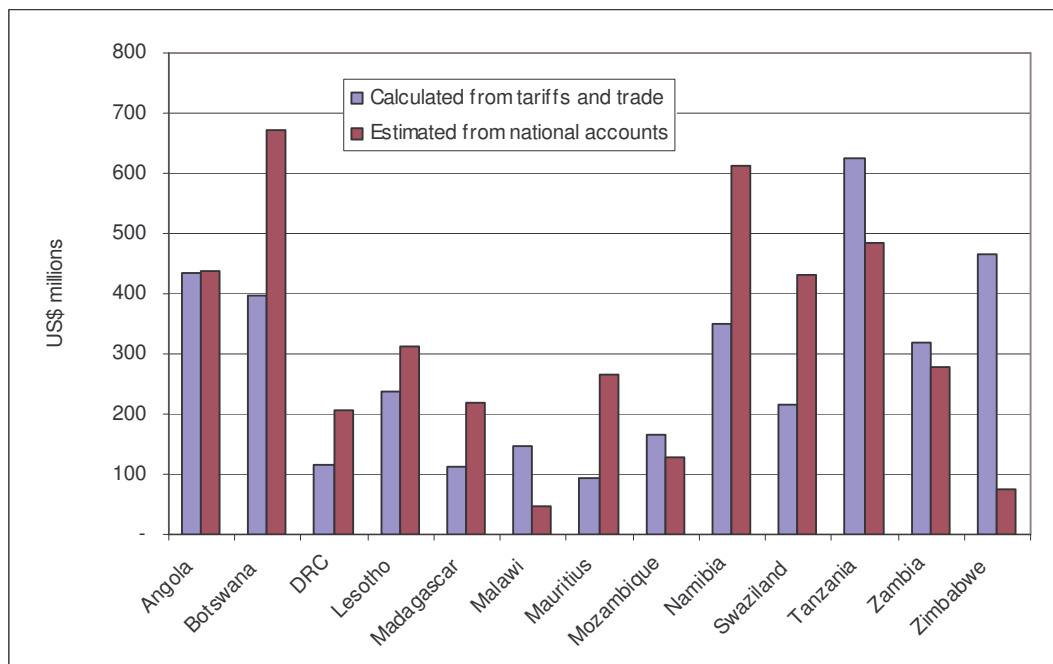
The calculations for Angola, Mozambique, Tanzania and Zambia correspond with national account estimates. Botswana, Lesotho, Namibia and Swaziland (BLNS) all record much more in trade taxes in their national accounts than our calculations suggest they should. This is because they receive substantial compensation through the SACU revenue sharing formula. Conversely, South Africa records substantially less than calculated because it is a net contributor to the SACU revenue pool (South Africa is not shown in the figure below for scale reasons only).

Importantly, the calculations show the revenue situation that would exist in the absence of SACU i.e. taxes are collected on the total imports of all SACU members, including intra-SACU trade. This is necessary to compare the situation for individual SACU members under different CET scenarios within a SADC customs union, and without a revenue sharing mechanism. The implications, strengths and weaknesses of the SACU Revenue Sharing Formula are dealt with in more detail in the following section.

Madagascar, Mauritius and the DRC also record more in trade taxes than we have calculated. This could be as a result of additional taxes on imports (Mauritius, for example, levies large excise duties on some goods, a substantial amount of the revenues wherefrom being collected at Customs and, until recently, recorded as import tax revenues) which are not captured in our calculations, or it could result from weaknesses in our own or the World Bank data. Malawi and Zimbabwe on the other hand, collect much less than our calculations suggest they should. This probably reflects the high level of intra-SADC imports recorded by land-locked SADC members, on which preferential tariffs are applied, but might also reflect data problems or low collection rates in these countries.

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Figure 7. Customs duties collected by SADC member states (most recent year for which data is available)



Source: Authors' calculations

It is important to be aware of these data problems but the focus of this analysis is on the relative impact of the four CET options and not on the absolute level of revenues collected. Table 17 shows our calculations of the amount of duties each country would expect to collect under its own MFN tariff and under the four different CET options described above. The SACU CET is particularly complex. Because this analysis was done at the six-digit HS level, it was necessary to consider the minimum and maximum 8-digit tariff applied by SACU in order to calculate a lower (Min.) and upper (Max.) bound of the duties each country would collect under this option.

The shaded blocks show where a country would experience a fall in total customs duties collected, of more than 10%. If the SACU minimum tariff or Mauritius tariff structure was applied as the common external tariff, all SADC member countries (except Mauritius) would experience a significant fall in customs duties). The situation is much less severe under the other 4 CET scenarios. In all cases, Malawi, Tanzania, Zimbabwe and Zambia would experience a decline in customs duties of 10% or more.

It is worth repeating that this comparative analysis disregards the revenue payments to the BLNS and South Africa under the SACU revenue sharing arrangement, and instead treats SACU countries as all other individual SADC member states. In truth, the BLNS would all see substantial reductions in revenues in moving from SACU to a new and neutral revenue dispensation, and South Africa would see a substantial increase in most cases (the Mauritius CET being the exception). The intra-SACU fiscal redistribution shown here should not be interpreted as an impact of the SADC CU, but rather as an indication of an issue that would have to be dealt with internally among SACU member states prior to or as part of process of joining a SADC CU that might not necessarily choose a revenue-sharing arrangement that reflects unique historical circumstances in SACU and that would be expected to apply to the broader SADC group.

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Table 17. Customs collections by country (most recent year for which data is available)

USD Millions	MFN	SACU		10%	Maur.	DRC
		Min.	Max.			
Angola	434	363	558	646	355	648
Botswana	396	262	396	298	95	316
DRC	115	80	136	98	59	115
Lesotho	238	159	238	132	63	207
Madagascar	114	57	111	120	58	141
Malawi	146	43	62	121	32	120
Mauritius	95	221	313	364	95	415
Mozambique	167	101	184	161	72	182
Namibia	351	223	351	250	201	353
South Africa	5,105	2,634	5,105	6,346	1,800	6,627
Swaziland	217	174	217	200	42	288
Tanzania	624	208	392	444	132	480
Zambia	320	107	245	257	98	285
Zimbabwe	465	90	176	217	74	214

Source: Authors' calculations

To fully understand the implication of the absolute change in customs duties shown above, it is important to consider the impact of these changes on the total government revenue within each member country. See Table 18 below. Here, shaded blocks show where a country would experience a fall in total government revenue, of more than 10%.

Nine of the 14 SADC member countries would experience significant falls in revenue if the Mauritius tariff was applied region-wide. The minimum SACU tariff would cause problems for 6 member countries, and at least two countries would experience large revenue adjustments under the other three options. Tanzania, Zimbabwe, Malawi, Madagascar and Lesotho are particularly vulnerable to tariff adjustments.

Table 18. Change in customs duty, relative to MFN tariff, as a % of total government revenue (most recent year for which data is available)

% change in total revenue	SACU		10%	Maur.	DRC
	Min.	Max.			
Angola	-0.9	1.6	2.7	-1.0	2.8
Botswana	-3.5	0.0	-2.6	-7.8	-2.1
DRC	-6.9	4.1	-3.5	-11.1	0.0
Lesotho	-14.6	0.0	-19.6	-32.4	-5.6
Madagascar	-16.1	-0.6	1.8	-15.9	7.9
Malawi	-29.0	-23.7	-7.1	-32.3	-7.4
Mauritius	11.3	19.7	24.4	0.0	29.0
Mozambique	-7.8	2.0	-0.6	-11.2	1.8
Namibia	-7.0	0.0	-5.5	-8.2	0.1
South Africa	-4.7	0.0	2.3	-6.3	2.9
Swaziland	-6.7	0.0	-2.6	-27.1	11.0
Tanzania	-32.0	-17.8	-13.8	-37.8	-11.1
Zambia	-21.9	-7.8	-6.5	-22.8	-3.6
Zimbabwe	-33.7	-26.0	-22.3	-35.1	-22.6

Source: Authors' calculations

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The analysis presented above is static and simplistic and does not try to show the positive impact that higher imports might have on revenue collections in the region. Moreover, the CET options described above are hypothetical and are not based on the recommendations to be made in the parallel Study No.2. Nevertheless, these calculations confirm that the majority of SADC countries are vulnerable to changes in customs duties and that the imposition of almost any CET is likely to require revenue adjustments in some member states.

3. The fiscal impact

The net economic effect depends not only on the impact of any change in customs duties on government revenue, but the importance of government revenue (and expenditure) in total GDP and on the ability of member states to raise other taxes in response to declining tariff revenues. These issues are considered briefly below.

Table 19 shows the contribution of different taxes to total revenue and the share of total revenue in GDP by member state. In those countries where duties constitute a high share of government revenue, government itself is pretty small. The only exceptions being Zambia and the BLNS. This would suggest that the scale of the 'shocks' described above might not be as critical as anticipated. It also confirms that the Lesotho, Swaziland and to a lesser extent Namibia and Botswana are going to experience extreme difficulties in moving from SACU to a SADC-wide CU without serious internal reforms or adjustment assistance.

Table 19. Fiscal indicators (2003)

	Trade taxes / Total revenue	Taxes on income and profits / Total revenue	Indirect taxes / Total revenue	Total Revenue / GDP	Budget deficit / GDP
Angola	5.9	85.0	13.7	37.5	-6.4
DRC	41.0	27.7	61.6	7.7	-3.9
Madagascar	49.0	14.2	80.7	10.3	-4.1
Malawi	11.0	37.4	48.4	22.6	-9.6
Mauritius	21.8	18.0	68.5	20.1	-6.2
Mozambique	15.1	22.0	70.6	14.3	-4.5
Tanzania	37.6	31.8	59.0	11.4	-2.1
Zambia	28.5	44.1	52.3	17.9	-5.8
Zimbabwe	6.8	53.4	43.0	23.5	-0.2
Botswana	n/a	65.4	20.7	40.1	-2.8
Lesotho	42.9	24.1	60.0	41.0	-0.6
Namibia	29.6	37.6	51.0	30.6	-6.9
Swaziland	37.6	25.2	71.5	25.3	-3.2
South Africa	2.9	57.9	39.9	23.6	-2.1

Source: World Bank 2005 (total revenue excludes grants; but in the case of SACU countries, trade taxes include net transfers resulting from the revenue sharing formula)

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In order to assess the scale of the revenue adjustment that might be required to offset reductions in customs duties, we look here only at the possible impact on indirect taxation (sales or value added tax). Table 20 below shows amount of customs duties collected according to our MFN calculations ('MFN'), estimates ('Est') obtained from World Bank publications and our analysis of what would be collected under a 10% flat tariff ('10%'). It also shows the likely loss in customs duties in moving from the MFN and estimated figures to the 10% tariff. The final three columns show the current VAT rate in all SADC member countries and the rate that would have to be levied to fully compensate for the loss in revenue that could be experienced in moving from the MFN and the estimated figures to a 10% tariff.

Consider, for example, the DRC. Our MFN calculations show that it should collect around \$115 in customs duties but World Bank data shows collections of more than \$200 million. Under a flat 10% tariff on all imports, we calculate that the DRC would collect \$98 million. So depending on whose figures (ours or the World Bank) are closest to the actual customs duties collected, the DRC stands to lose between \$18 and \$110 million in customs duties under a 10% tariff. The current indirect tax rate in the DRC (a turnover tax on production) is 13%. To fully compensate for the loss in customs duties arising from the implementation of the 10% tariff, the DRC would need to raise this tax by between 0.7 and 4.2 percentage points – again, depending on the accuracy of our MFN or the World Bank's estimated collections.

Table 20. Revenue (VAT) adjustment required to offset reductions in customs duties

	Collected			Loss (-)		VAT		
	MFN	Est	10%	MFN	Est	Current ¹⁹	MFN	Est
Angola	434	455	646	212	191	10.0	8.7	8.9
Botswana	396	673	298	-98	-375	10.0	11.1	14.4
DRC	115	207	98	-18	-110	13.0	13.7	17.2
Lesotho	238	312	132	-106	-181	14.0	18.2	21.1
Madagascar	114	171	120	6	-51	17.0	16.8	19.1
Malawi	146	42	121	-25	79	17.5	19.4	11.4
Mauritius	95	250	364	269	115	15.0	10.3	13.0
Mozambique	167	142	161	-5	19	17.0	17.1	16.5
Namibia	351	612	250	-101	-362	15.0	16.6	20.7
South Africa	5105	1709	6346	1241	4637	15.0	14.2	11.9
Swaziland	217	430	200	-17	-230	14.0	14.5	20.5
Tanzania	624	524	444	-180	-80	20.0	24.4	22.0
Zambia	320	371	257	-63	-114	17.5	19.1	20.4
Zimbabwe	465	76	217	-248	141	15.0	25.9	8.8

Source: Authors' calculations

It is important to re-emphasise that the purpose of this analysis is not to provide accurate estimates of current and future customs collections for all or any one member state, but is to highlight the likely scale of the problem and identify countries likely to be most vulnerable to changes in import taxes. This particular analysis suggests that almost all SADC member states could manage the revenue adjustment expected from modest tariff reform (a 10% flat tariff) through minor adjustments to other taxes (or through the improved administration or collection of existing non-trade taxes). Lesotho, Swaziland and to a lesser extent Zambia and Namibia, are the main exceptions. The Zimbabwe, Malawi and Tanzania figures are distorted by our high calculations of customs collections under a MFN tariff.

4. Other economic considerations

¹⁹ Estimates provided by the SADC Secretariat.

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As explained in Section C there is often considerable confusion in discussions about the economic implications of revenue losses from trade liberalization. In practice, the economic effects of any given set of trade policy change will depend entirely on what is actually done; as Section A indicated there is a wide range of possibilities, and as was explained in Section B there are several legitimate reasons why, for example, transactions costs at internal borders may not disappear.

Some policy makers, especially in Ministries of Finance and Customs Departments, treat customs revenue losses as a cost of trade liberalization. While any revenue losses on existing imports represent a loss to the members' government treasuries, they are not an economic cost to the countries' citizens. They represent simply a transfer from the treasury to the users of imported goods. There is no net change in total economic welfare as a result of this transfer (except to the extent that revenues losses are made up through higher cost revenue sources, as discussed further below).

To the extent that the tariff reductions and more general freeing of intra-CU trade encourage trade creation and/or a reduction in the price of domestically produced import substitutes, there is a net economic gain to the country's citizens—i.e. the revenue losses to national treasuries are smaller than the gains to users of imported goods. The increases in productive efficiency and consumer welfare arising from trade creation exceed the customs revenue losses arising from liberalization. The net benefit measured by this difference is the familiar, but too often forgotten gains from trade that are the principal motivation for trade liberalization.

In the case of trade liberalization towards a selected group of trade partners (rather than on an MFN basis) there may be additional revenue losses due to trade diversion. Tariff reductions on intra-SADC trade may encourage importers to switch from low-cost international suppliers to higher cost SADC sellers. This might be a more serious danger in some of the smaller, less developed Member States. But it would occur only if a) implementation of the existing Trade Protocol is incomplete, due to other barriers to intra-SADC trade, from logistics to weaknesses in customs and more general trade facilitation and b) the CET that is adopted by the CU increases rather than decreases protection against imports from the rest of the world. Whilst the latter might occur in some CU members, it might be difficult for it to occur across-the-board without breaching WTO requirements under Article 24. Even without this constraint of multilateral rules, it would be unlikely and certainly irrational in the face of completion of EPAs with the EU (see Section A) and further progress in general MFN-based trade liberalization.

To the extent that revenue losses are due to trade diversion, there is a net economic cost. However, the economic cost is not the total amount of the revenue loss. Rather, it is only the difference between the higher cost of SADC-sourced imports compared with what they would have cost if bought from the lowest cost source. The revenue loss is an upward-biased estimate of the loss from trade diversion. The size of this bias is larger the smaller is the difference between MFN tariff rates and preferential SADC rates on the diverted goods.

If revenue losses do not represent significant economic costs, why are they the source of so much attention in trade negotiations? One reason, of course, is that Ministry of Finance and Customs officials, who have a portfolio interest in revenue issues, often play a large role in the negotiations. Their interest is more acute in countries with weak revenue systems, and especially in those that operate on the basis of collection targets. Like any other such interest, their concerns should be balanced against the broader national interest when developing and implementing strategies for trade policy reform.

There is also, however, a potentially legitimate concern about revenue losses in countries with weak revenue systems. In such systems, tax collection has high direct costs, and also creates serious distortions in economic incentives. As a result, the economic cost of public sector revenues can be very high. In the face of these constraints, poorer countries tend to rely relatively heavily on taxes on international trade. To forgo revenues from this source might make it necessary to rely on revenue sources with higher economic costs of tax collection. The resulting additional economic costs are another cost of revenue losses from tariff reductions. Once again, the cost is not measured by the size of the revenue losses, but rather by the difference in the economic costs of collecting revenues from alternative sources (or of reducing the amount of government expenditures as a result of revenue losses).

Taxes on trade are a *relatively* low cost revenue source in poor countries. However, in absolute terms trade taxes are still very costly. This is why countries switch to other taxes, levied primarily on income and consumption, as quickly as possible in the process of economic development. Most SADC Member States are already well along in programs for the modernization of their tax systems.

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A key element in these programs is the introduction of value-added taxes, which are much more productive at revenue-raising and distort economic incentives far less than trade taxes. Value-added taxes have an additional advantage for countries like the SADC Member States in that a large share of collections takes place at international borders, but without the adverse production incentives created by import duties.

In this context, revenue losses that occur as a result of a SADC CU (and even more so as a result of MFN-based tariff reduction programs) should be seen as part of the general process of tax reform being undertaken in the Member States. Any acceleration of the tax reform process arising from a SADC CU should be seen as an additional benefit rather than a cost. In any case advance planning for implementation of a SADC (and of the SADC FTA at present) allow for a gradual phase-in of any SADC-related revenue losses and provides more than adequate time to make necessary policy adjustments. Mauritius has recently undertaken a bold unilateral reform of its own tariff and tax structure and has already reduced its reliance on import duties from 14 to less than 6 percent of total tax revenues in only four years.

Recent research has shown that tax reform as an accompanying measure to tariff reform is not automatic, and not all countries have been managed to completely make up for tariff revenue losses with other domestic tax collections, especially in the context of IMF- and World Bank-mandated structural adjustment programs. This does not mean it cannot be done; rather it means that a certain amount of fiscal planning is necessary and the level of the 'compensating' domestic taxes must be set high enough to cope with lower than planned collection rates. An important fact in this regard is that by far the single most important point of revenue collection in almost any VAT system in the world is the country's border. In that sense, a VAT and most other forms of sales and excise tax are administratively quite similar to import tariffs. The administrative requirements of reducing reliance on import duties might be much less daunting than they might initially appear to be. (The much greater challenge, will be to find ways to harmonize and coordinate VAT systems in a way to reduce border frictions in intra-CU shipments of goods – a consideration that reinforces the point made above that a CU with free trade will not necessarily remove transactions costs at internal borders.)

Of equal importance is that the SADC CU is not an externally imposed adjustment program; it is an internally generated initiative. As such members might well see domestic tax reform as an area in which assistance will be sought and provided as part of a program to maximize the benefits from a SADC CU (and maybe for any other forms of tariff and trade policy reform).

SECTION F: ECONOMIC IMPACT ANALYSIS

1. Framework and Empirical Methods

SADC economies are in the process of implementing a Free Trade Agreement (FTA). Under the SADC Regional Indicative Strategic Development Plan (RISDP) adopted in August 2003, SADC economies have envisaged the establishment of a Customs Union (CU) by 2010, a Common Market by 2015 and a Monetary Union by 2016.

The economic analysis in this section focuses on the implementation of a customs union. In the discussion of forms of regional agreements presented above, a customs union implies a deeper degree of integration than a free trade area. Nevertheless, many of the trade-induced adjustments to economic structure will likely be brought about through the implementation of the SADC free trade area. The likely incremental impacts of a customs union arise via:

- Changes to external tariffs of each country through application of a common external tariff (CET),
- Revenue gains/losses from the CET and the adoption of a revenue sharing rules,
- Gains from the elimination of rules of origin, and
- Deep integration encompassing issues such as institutions, foreign direct investment, infrastructure, and domestic regulatory impediments to trade, among others.

In this section, we focus on these incremental economic effects of a customs union using a variety of empirical methods. The overall framework is drawn from Evans et al. (2006) and makes an important distinction between “shallow integration” and “deep integration”. Shallow integration involves the elimination of barriers, primarily tariff barriers, which inhibit the movement of goods and services across national borders within the region. Deep integration involves the building of a physical and institutional environment to encourage trade and facilitate segmentation of production processes and value chains.

The structure of the empirical assessment follows this distinction. The effects of shallow integration are first analysed, both in the context of the existing FTA and the proposed CU. The analysis then explores the economic effects of deeper integration. In all cases, we concentrate on the static re-allocation effects from integration and do not estimate the dynamic growth effects that may arise from different integration scenarios.

A multiple region computable general equilibrium (CGE) model was developed explicitly for the purpose of examining the economic implications of various customs union scenarios. More detail on this model is provided in the appendix.

2. General equilibrium analysis of shallow integration

2.1. Simulations considered

Even though SADC member countries have targeted the establishment of a customs union by 2010, the exact shape of the customs union remains to be defined. Five simulations are presented. These simulations are not specific policy proposals. Rather, the five simulations were chosen with the goal of exploring the available policy space in the hope of productively orienting the policy debate. The five simulations are presented in Table 21.

Table 21: Simulations.

Number	Identifier	Description
1	FTA	Implementation of a free trade area within SADC
2	MFN	SADC FTA plus reductions in all other tariffs by 25%
3	Unif10	A SADC customs union with a 10% uniform common external tariff
4	Unif5	A SADC customs union with a 5% uniform common external tariff
5	ZAF	A SADC customs union with common external tariffs as in SACU

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The first simulation is necessary to consider the ongoing implementation of the SADC trade protocol. The second simulation considers implementation of a free trade area accompanied by a 25% reduction in tariffs applied to goods sourced from outside of SADC. The remaining scenarios all relate to formation of a customs union. Three separate common external tariffs are simulated: (a) a uniform 10% external tariff, (b) a uniform 5% external tariff, and (c) application of the external tariffs from SACU.²⁰

There are two important revenue related issues to highlight. First, in all of the customs union scenarios, tariff revenue is distributed according to the destination principle. As such, tariff revenue accrues to the country that either uses the imported good in final demand or as an intermediate in the production of another good. The choice of application of the destination principle reflects ease of interpretation of the principle and a high degree of consistency with the free trade area.

The application of the destination principle in the modeling *does not* reflect endorsement of the destination principle. Indeed, there exist some compelling arguments against the destination principle in the context of SADC (see Section C). Alternative revenue sharing formulas simply involve intra-SADC transfers of resources. The first order impact of a transfer of a unit of currency from one country to another involves a welfare loss in the amount of the transfer in the source country, which is exactly equivalent to the welfare gain in the recipient country. One can thus estimate the implications of alternative revenue sharing formulae based on the existing results.²¹

Second, lost tariff revenue is replaced via an income tax. For lesser developed SADC economies this may be an unrealistic revenue replacement option and they would have to increase other indirect taxes, such as VAT or sales taxes. The welfare implications of this are discussed where relevant.

2.2. Results

The implications of each scenario for overall household welfare are presented in **Error! Reference source not found.** 22. The country level results are presented in percentage change. The absolute welfare change for the SADC region as a whole is presented in millions of 2001 US dollars. A number of observations emerge from the table. First, for SADC as a whole, all of the simulations generate improvements relative to the 2001 base. Second, the customs union scenarios provide greater welfare gains.²² This points to benefits from rationalization of external tariff schedules even though only a single structure can be adopted. Third, while some countries experience welfare losses in some scenarios, the losses are typically small in both percentage and absolute terms (note that the largest economy in the region, South Africa, gains in every scenario). According to these results, relatively small transfer would suffice to generate gains in all regions.²³

The remainder of this section is dedicated to investigating these results in greater detail.

Table22: Welfare impacts of scenario (percentage change from 2001 base values).

	FTA	MFN	Unif10	Unif5	ZAF
Botswana	0.0	0.6	0.6	1.4	0.4
Malawi	1.6	1.4	0.6	0.7	1.9
Mozambique	-0.4	-0.2	-0.2	0.1	-0.4
Rest of SACU	1.6	1.7	1.8	1.6	0.9
Rest of SADC	-0.3	0.4	1.6	1.4	1.1
South Africa	0.4	0.3	0.8	0.3	0.2

²⁰ Operationally, we apply the base tariff rates for South Africa from the GTAP database version 6.0.

²¹ These estimates will not be exact. As foreign currency is being transferred, some adjustments in trade patterns will also be required in order to compensate for the change in foreign currency availability. Nevertheless, the first order estimate is likely to be a reasonable first approximation of the welfare effects.

²² This occurs even though the model does not account for the implications of rules of origin in the FTA and MFN scenarios.

²³ For example, for the scenario Unif10, the total value of losses in Mozambique and Zambia represent less than four percent of the total gains.

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Tanzania	-0.2	-0.2	0.0	-0.1	-0.3
Zambia	-0.4	-0.3	-0.6	-0.1	-0.3
Zimbabwe	0.1	0.2	0.2	0.2	0.3
Total (\$ million) ¹	285.8	330.3	824.9	489.3	331.0

¹This last row is presented in millions of 2001 USD.

In the GTAPinGAMS model, welfare gains are achieved through reallocation of resources to more efficient sectors and through changes in terms of trade. We focus first on the terms of trade effect. When a tariff is removed on a given commodity, the immediate impact is to reduce the relative price of that commodity. With a lower price, demand by consumers and firms increases. However, this increase in demand for the imported commodity generates disequilibrium in the product market as demand exceeds supply. The path to re-establishing equilibrium depends in large measure on the flexibility of the economies in question. Less flexible economies are less capable of shifting resources. As a result, shocks, such as a reduction in tariffs, generate relatively small shifts in quantities and relatively large shifts in prices. More flexible economies, on the other hand, accommodate shocks via reallocation in resources. Quantities of production, trade, and final demand shift while prices tend to remain relatively stable.

These substitution possibilities are governed in large measure by so-called “Armington elasticities”. The GTAP database provides econometrically estimated values for these elasticities. And, these standard values were employed in the simulations presented in Table 22.

The relative importance of quantity versus price adjustment also depends upon the time frame considered. In the short run, changes in the structure of production, imports, and exports may be difficult to achieve. Hence, short-run shocks, such as international price shocks, often involve substantial movements in relative prices. Over long time frames, the capacity of the economy to adjust obviously increases. This enhanced adjustment capacity over time provides the logical basis for publication of the content of agreements well in advance and a gradual phase-in of tariff rate changes, which has been the policy in the implementation of the SADC trade protocol.

The trade elasticities employed in the GTAPinGAMS model reflect a medium run time frame of approximately 2-3 years. The elasticity values are set at middle ranges implying that adjustment to tariff reforms has implications for both prices and quantities. Movements in prices of internationally traded goods imply that terms of trade are likely to change. If the prices for a country’s exports decline and the prices for a country’s imports increase as a result of tariff reform, welfare gains from improved allocation of resources may be swamped by welfare losses stemming from a deterioration in the terms of trade. **Error! Reference source not found.** 23 provides changes in terms of trade for the scenarios considered.

Table 23: Terms of trade impacts (percentage change).

	FTA	MFN	Unif10	Unif5	ZAF
Botswana	-0.4	-0.1	-0.5	0.0	-0.2
Malawi	2.0	1.4	0.2	-0.1	2.1
Mozambique	-0.9	-0.8	-0.5	-0.6	-0.9
Rest of SACU	1.5	1.2	1.2	0.7	1.0
Rest of SADC	-0.6	-0.8	-0.7	-1.2	-1.1
South Africa	0.6	0.1	1.1	-0.1	0.3
Tanzania	-0.6	-1.2	-0.9	-2.0	-1.5
Zambia	-0.7	-0.6	-0.8	-0.5	-0.6
Zimbabwe	-0.2	-0.3	-0.7	-0.8	-0.3

It is worthwhile to point out that, in every case where a country experiences an overall decline in welfare, negative terms of trade effects contribute to the welfare losses. Sensitivity analysis with higher trade elasticities (e.g., more flexible response corresponding, for example, to a longer time frame) reveals that, in all cases, the welfare losses are either significantly ameliorated or reversed

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(more often reversed). In addition, overall welfare is significantly higher (more than double for some scenarios and slightly less than double in others) as the capacity of each economy to specialize in sectors of comparative advantage is enhanced. These results highlight the importance of a credible and well-publicized transition period to the new policy environment.

The importance of tariff revenue to the public finances of SADC members, especially the less developed members has been emphasized repeatedly. The GTAP database (and hence downstream models such as GTAPinGAMS) is designed to focus on real resource allocation effects from trade liberalization. As a result, the model is not ideally suited for revenue analysis. For example, tariff rates in GTAP are meant to reflect the costs of a marginal unit of imports. As a result, the tariff rates in GTAP tend to more closely reflect posted tariff rates. However, revenue collections are often significantly below the values implied by posted tariff rates multiplied by the value of imports due to, for example, official exemptions (Arndt and Tarp, 2007 and Edwards and Lawrence, 2007). In short, models based on the GTAP database tend to overstate the absolute level of tariff revenue and the changes in revenue implied by trade liberalization.

Despite these caveats, the changes in tariff revenue generated in the simulations are instructive as they provide a reasonable comparator across scenarios for direction of change (will revenues increase or decrease?) and relative magnitude of change. Table 24 provides these changes measured as a share of GDP. As might be expected, implementation of the FTA reduces revenues in all member countries and the addition of tariff cuts on a most favoured nation basis (MFN) results in further revenue declines. In the customs union scenarios, application of the SACU tariff structure to the SADC customs union (scenario ZAF) results in revenue declines in all SADC countries relative to the 2001 base (recall that, in the model, revenue is allocated using the destination principle). The scenario ZAF also results in revenue declines relative to the FTA in all cases except Botswana.

Table 24: Change in tariff revenue as a share of GDP.

	FTA	MFN	Unif10	Unif5	ZAF
Botswana	-0.2	-0.2	0.4	-0.1	-0.1
Malawi	-2.6	-2.8	-2.2	-3.0	-3.0
Mozambique	-2.5	-2.7	-1.5	-2.4	-2.8
Rest of SACU	-0.2	-0.4	1.1	-0.2	0.0
Rest of SADC	-1.8	-2.7	-2.7	-4.9	-5.4
South Africa	0.0	-0.3	0.9	-0.2	0.0
Tanzania	-0.7	-1.2	-0.6	-1.8	-1.7
Zambia	-2.2	-2.3	-1.5	-2.1	-2.4
Zimbabwe	-1.7	-1.8	-1.4	-1.8	-1.9

The customs union scenarios with uniform 5% (Unif5) and uniform 10% (Unif10) external tariffs bracket the revenue performance of the FTA scenario. A uniform 5% external tariff typically provides less revenue than under the FTA. Under the uniform 10% external tariff, most members lose revenue relative to the 2001 base but gain revenue relative to the FTA. For the customs union as a whole, total revenues increase mildly driven by the revenue gains in South Africa.

This result implies that an external tariff structure with two rates (say 5% for intermediates and capital goods and 10% for consumption goods) would yield SADC wide an approximately similar or improved revenue value relative to the FTA.²⁴ These two scenarios are already the most favourable in terms of overall welfare. A two rate policy as described above would yield similar welfare gains and obviate the need to search for revenue replacement at a SADC wide level. This is significant. The GTAPinGAMS model replaces lost tariff revenue via an income tax (modeled as a non-distorting lump sum tax). Unfortunately, this is an unrealistic revenue replacement option in the lesser developed SADC

²⁴ Actual receipts would depend upon many factors such as the actual characterization of goods as capital/intermediates or consumer goods. This is not always obvious. For example, should a pickup truck be characterized as a capital/intermediate good or a consumer good? The ability of authorities to constrain tariff evasion and the willingness of authorities from granting official exemptions will also have significant impacts on revenue.

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economies. Realistically, these economies would have to increase other indirect taxes, such as VAT or sales taxes. These taxes will cause their own distortions and reduce welfare from the levels presented in Table 25. This reality further increases the attractiveness of the scenarios with uniform 5%, uniform 10%, or (most likely) some combination thereof.

A crucial issue throughout SADC is employment. Trade policy reform is highly likely to influence the structure of employment as trade policy reform tends to engender relative expansion in some sectors and relative contraction in others. Trade policy reform also has the potential to change the overall level of employment. Short term changes in overall employment could occur as a result of adjustment costs with shrinking sectors shedding jobs more rapidly than expanding sectors create jobs causing some short term dislocation. The potential for employment adjustment costs also underscores the aforementioned need for a transparent and credible transition period.

Trade reform also has the potential to change overall employment levels over the longer-term. Trade reform may cause structural shifts that induce greater (less) labour demand by encouraging growth (contraction) in labour intensive industries. In addition, if the improved resource allocations and links to international markets foster growth, this growth will translate into enhanced employment. Unfortunately, the GTAPinGAMS model incorporates neither short run adjustment costs nor long run growth dynamics. It can shed some light on whether reform tends to expand demand for labour.

We investigate this issue indirectly. Rather than allow the trade reform to expand employment, we fix total employment and examine the impact of trade reform on the wage. This is done for a number of reasons. First, unemployment in nearly all trade models, including GTAPinGAMS, is represented by a fixed institutional wage (such as a minimum wage) set above the level that would allow full employment. Employment levels in these trade models are highly sensitive to this institutional wage, and it is not clear how the institutional wage will change in response to trade policy reform. Second, the implications of changes in the overall level of employment for aggregate welfare are large. Given that trade policy is not as powerful an instrument as labour market policy in influencing overall employment (in a static setting), it seems wiser to abstract from these changes. Finally, for technical reasons, changing the mix between direct and indirect taxation levels will impact factor returns generating further difficulties in simulating a neutral wage policy. In particular, increases (decreases) in tariff revenues will generate a tendency for a reported decline (increase) in factor returns. In the aggregate, changes in factor returns due to changes in indirect tax revenues (such as tariff revenue) have no direct welfare implications because they are offset by changes in direct tax revenues (recall that, consistent with standard practice in public finance, all scenarios are assumed to be revenue neutral with direct tax rates adjusting to meet the revenue target). These technical considerations imply that factor return results across scenarios and across regions require care in interpretation.

Factor returns, including wages, are presented in Table 26 below. All returns are measured relative to the consumer price index in each region. First, let us address the technical considerations discussed above. Note that factor returns, for every factor and in every region, are always lower in the scenario Unif10 compared with the scenario Unif5. This result is driven purely by the higher level of tariff revenue in the former scenario. It does *not* mean that, for example, unskilled labour (LAB) is necessarily worse off in scenario Unif10 versus Unif5.

The most robust interpretations of the results involve comparisons of relative factor returns in a given scenario and region. For example, in the FTA scenario for Botswana, returns to labour increase by more than all factors excepting the natural resource factor. Hence, the FTA mildly favours labour relative to other factors in Botswana. This kind of comparison indicates that trade reform can have distributional implications including winners and losers. For example, the results indicate that owners of land (LND) in the Rest of SACU region are likely to experience losses relative to owners of other factors of production.

In terms of the labour market and focusing on unskilled labour (LAB), we find that returns to labour typically either stay broadly in line with returns to other factors or increase relative to other factors. There are no scenarios where returns to labour fall drastically relative to the prices of other factors. Based on these wage results, one can infer employment results in a scenario where employment adjusts to the level dictated by economic conditions and the level of the institutionally set wage (rather than the wage adjusting to maintain a constant level of employment as is modeled). Assuming policy is to keep (the institutionally set) unskilled wage at a roughly constant ratio of returns to other factors,

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then the results indicate a largely neutral impact on overall employment with perhaps a mild tendency for employment creation in most SADC regions under most scenarios. Not surprisingly, the regional trade scenarios influence trade flows, sometimes substantially. For all countries, intra-SADC trade grows, sometimes dramatically.²⁵

Table 25: Changes in factor prices.¹

		FTA	MFN	Unif10	Unif5	ZAF
Botswana	CAP	1.3	1.9	0.7	2.4	1.4
	LAB	1.5	2.0	0.6	2.4	1.6
	SKL	1.4	2.0	0.9	2.5	1.5
	LND	-0.9	-0.9	-5.4	-4.2	-1.4
	RES	2.1	2.6	17.9	10.3	1.6
Malawi	CAP	2.7	3.4	2.6	4.1	3.3
	LAB	1.4	2.6	2.3	4.4	2.1
	SKL	1.4	2.5	2.6	4.3	2.0
	LND	-12.3	-6.2	-0.6	6.2	-10.7
	RES	-7.9	-4.7	4.4	4.3	-7.2
Mozambique	CAP	4.9	5.6	3.8	5.8	5.4
	LAB	4.7	5.3	3.9	5.7	5.0
	SKL	5.4	6.2	5.1	7.0	6.0
	LND	0.1	0.3	0.3	0.5	-0.7
	RES	0.6	1.6	-0.2	2.3	0.1
Rest of SACU	CAP	1.1	2.1	0.1	2.9	1.0
	LAB	0.5	1.5	-0.3	2.4	0.5
	SKL	0.5	1.6	0.2	2.8	0.6
	LND	-9.0	-9.8	-20.3	-17.4	-7.2
	RES	-4.0	-1.4	-1.6	3.0	-3.1
Rest of SADC	CAP	3.9	6.0	7.3	10.9	10.0
	LAB	3.9	6.1	7.5	11.1	10.2
	SKL	3.9	6.1	8.5	11.8	10.4
	LND	-1.0	-0.4	0.4	0.3	4.3
	RES	5.6	7.8	4.4	11.2	12.5
South Africa	CAP	-0.3	0.7	-1.4	1.3	-0.1
	LAB	-0.2	0.7	-1.0	1.4	-0.1
	SKL	-0.3	0.6	-0.9	1.5	-0.1
	LND	1.0	1.2	-5.2	-2.3	2.0
	RES	-3.0	0.0	-7.5	1.2	-1.9
Tanzania	CAP	0.9	2.0	1.3	3.6	2.4
	LAB	0.9	1.9	1.4	3.5	2.1
	SKL	0.9	2.0	1.7	3.8	2.4
	LND	1.0	1.9	1.6	3.3	1.7
	RES	0.0	0.6	-0.3	1.0	-0.4
Zambia	CAP	3.7	4.3	2.5	4.4	3.9
	LAB	2.8	3.2	1.7	3.2	3.0
	SKL	3.1	3.6	2.1	3.7	3.3
	LND	1.1	0.9	-0.7	-0.1	1.8
	RES	-1.6	0.4	-7.7	-0.8	-1.0
Zimbabwe	CAP	2.4	3.0	2.0	3.5	3.1
	LAB	2.9	3.4	2.3	3.9	3.7
	SKL	2.3	2.8	2.1	3.6	3.0
	LND	13.7	15.5	10.7	16.1	16.6
	RES	-1.7	0.6	0.0	4.6	-0.1

²⁵ The reader is cautioned that large percentage changes can easily occur on small flows.

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¹All factor price changes are relative to the consumer price index (CPI) in each country.
LND refers to land, CAP refers to capital, SKL refers to skilled labour, LAB refers to unskilled labour and RES refers to natural resources.

For SACU members, the elimination of trade barriers by other members of SADC sometimes implies that trade patterns switch from SACU to SADC. The impact on trade with the rest of the world depends upon the scenario and the region. For SADC economies, particularly, Malawi, Mozambique, Rest of SADC, Tanzania, Zambia and Zimbabwe, there is evidence that exports and/or imports shift from the rest of the world to SACU. This may reflect trade diversion. However, by lowering the external tariffs, the CU scenarios appear to reduce this effect. In terms of total exports and total imports of SADC members, all scenarios increase the total value of trade with the exception of Unif10, which leaves total value of trade marginally less than the value registered in the base data.

Table 26: Percentage changes in exports and imports.

			FTA	MFN	Unif10	Unif5	ZAF
Botswana	Exports	ROW	-0.5	0.2	-1.6	0.9	-0.3
		SACU	0.0	-8.6	3.1	-14.2	0.0
		SADC	17.3	8.7	17.0	0.8	16.3
		Total	0.9	0.9	-0.1	0.9	1.0
	Imports	ROW	1.2	4.9	-2.8	9.8	3.2
		SACU	-3.0	-4.3	-3.2	-6.0	-3.5
		SADC	0.9	-0.6	0.1	-2.8	0.3
		Total	1.0	1.1	-0.8	1.1	1.2
Malawi	Exports	ROW	-11.1	-6.5	-3.6	1.9	-10.4
		SACU	247.6	201.4	143.1	108.6	247.8
		SADC	122.5	98.4	71.3	51.0	123.4
		Total	8.3	8.7	7.2	9.1	9.1
	Imports	ROW	-14.5	-9.9	-14.5	-4.0	-4.6
		SACU	36.5	31.5	29.7	23.0	28.0
		SADC	33.7	28.8	26.8	20.5	26.4
		Total	11.0	10.6	7.4	9.0	11.8
Mozambique	Exports	ROW	2.8	4.0	-2.5	2.4	3.6
		SACU	11.9	10.4	13.3	10.3	12.7
		SADC	14.1	12.7	14.4	11.9	14.5
		Total	6.4	6.7	2.8	5.4	7.0
	Imports	ROW	-13.2	-10.2	-18.4	-9.5	-9.3
		SACU	26.6	23.8	25.4	20.4	23.2
		SADC	24.9	22.3	24.0	19.1	21.7
		Total	4.6	5.0	1.5	3.9	5.2
Rest of SACU	Exports	ROW	-9.9	-6.5	-9.7	-1.8	-6.6
		SACU	-8.5	-11.9	-4.7	-13.8	-6.2
		SADC	29.7	23.9	24.8	14.4	21.0
		Total	3.1	3.5	1.6	3.5	2.5
	Imports	ROW	3.4	6.8	-0.9	9.3	-0.6
		SACU	2.9	1.1	2.9	-1.1	3.9
		SADC	4.2	2.4	4.2	0.2	5.1
		Total	3.9	4.0	2.3	3.6	3.0
Rest of SADC	Exports	ROW	3.2	4.7	3.5	7.5	6.2
		SACU	46.1	44.6	133.9	102.5	100.8
		SADC	28.3	23.6	47.5	34.4	38.0
		Total	3.6	4.9	4.1	7.9	6.6
	Imports	ROW	-7.7	-4.4	-2.4	2.7	0.5
		SACU	109.2	88.2	55.6	42.1	50.7
		SADC	112.8	92.1	60.5	46.9	56.2
		Total	2.9	4.1	3.1	6.5	5.3

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Table 27 Changes in output, exports, and imports (continued).

			FTA	MFN	Unif10	Unif5	ZAF
South Africa	Exports	ROW	-3.6	-0.9	-6.4	0.6	-1.9
		SACU	0.6	-1.0	0.5	-3.0	1.0
		SADC	21.9	17.4	14.7	9.3	13.1
		Total	0.6	2.1	-3.0	2.0	0.5
	Imports	ROW	0.9	2.7	-3.6	2.5	0.2
		SACU	-7.0	-11.4	-3.3	-13.9	-5.1
		SADC	12.8	7.1	14.2	3.0	15.4
		Total	1.6	3.0	-2.5	2.6	1.1
Tanzania	Exports	ROW	3.4	7.0	5.2	13.0	10.1
		SACU	25.4	19.8	36.2	22.5	34.6
		SADC	47.4	40.9	44.5	34.9	52.0
		Total	4.5	7.9	6.1	13.6	11.2
	Imports	ROW	-7.4	-3.6	-3.6	2.7	0.6
		SACU	96.0	76.4	63.5	43.0	49.2
		SADC	97.9	78.2	65.5	44.8	53.8
		Total	2.3	4.0	2.7	6.6	5.5
Zambia	Exports	ROW	4.1	5.3	2.1	5.5	4.8
		SACU	19.3	14.6	23.1	12.4	18.2
		SADC	15.6	10.9	18.2	8.0	14.8
		Total	5.8	6.1	4.5	5.9	6.2
	Imports	ROW	-16.3	-12.8	-21.4	-11.4	-11.3
		SACU	29.7	27.4	30.6	25.4	26.0
		SADC	23.5	21.4	24.8	19.8	20.3
		Total	5.1	5.5	3.5	5.4	5.7
Zimbabwe	Exports	ROW	0.3	2.2	0.2	4.9	2.0
		SACU	72.5	62.9	65.9	50.7	72.8
		SADC	56.9	49.6	51.6	40.1	55.4
		Total	9.2	9.7	8.3	10.5	10.4
	Imports	ROW	-19.6	-15.1	-16.4	-6.2	-6.3
		SACU	41.0	37.6	34.3	29.4	30.2
		SADC	33.6	30.6	27.9	23.7	24.7
		Total	9.6	10.0	8.0	10.2	10.7

3. Analysis of deep integration

Our analysis so far has focussed mainly on an economic analysis of tariff reductions, i.e. shallow integration. *Shallow* integration is an important source of potential gain, but needs to be complemented by deep integration policies in order to maximise the returns from the formation of a RTA, whether a FTA or a CU.

Deep integration implies the implementation of policies that facilitate economic integration and adjust institutions. By *deep* integration we understand policies that often go beyond the national domain. For example, policies that harmonize indirect taxation, competition policies, policies that facilitate investment and labour mobility across countries, policies that create cross-border infrastructure, or policies that guarantee exchange rate stability between the RTA members. In other words, policies oriented to achieve *deep* integration are policies aimed to achieve a common market, facilitating trade flows and shaping production to expand across the border of the RTA.

Deep integration clearly requires substantial reform of domestic policies, the development of cross-border institutions and a significantly greater degree of cooperation amongst partners. In some cases this may lead to a loss of national sovereignty in policy making, which may account for some country's reluctance to adopt them. However, negotiating these within the context of a CU also enables countries to lock in reforms or even adopt existing institutions from regional partners. One of

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the interests for Mexico in joining NAFTA, for example, was the ability to adopt credibility of US institutions.

A comprehensive overview of all deep integration policies is beyond the scope of this project. Important motivations for continued efforts at trade facilitation were presented in section 4.2, which focused on barriers to international trade. Here, we present further analysis of rules of origin. A customs union represents a further step towards greater regional integration in large part because a well functioning obviates the needs for such rules. In addition, we employ the GTAPinGAMS model to explore the scope for and distribution of gains from reductions in transport costs. Finally, a more general discussion of deep integration and investment is presented.

3.1. Rules of origin

An important benefit of a customs union is that it provides a mechanism to deal with restrictive rules of origin. While a FTA reduces intra-regional tariff barriers, differences in external tariffs necessitate rules of origin to prevent unfair re-routing of products to countries with low external barriers. Within SADC these RoOs are characterized by high costs of compliance and are a *de facto* deterrent for potential integration (See Erasmus, Flatters and Kirk, 2006, and, Brenton, Flatters and Kalenga, 2005).

The CGE model results for the CU do not explicitly capture the benefits arising from less restrictive rules of origin. The welfare gains from a CU are therefore expected to be larger on average than those identified earlier.

3.2. Transport cost as a barrier to trade

Economic infrastructure such as transport, communication, power, water and sanitation systems provide the foundation for economic activity and trade flows within an economy. In addition to its effect on economic growth, the provision of good infrastructure lowers transaction costs associated with exporting and importing and also facilitates the diversification of export production (Elbadawi, 1999). Further, lower transport costs can give rise to powerful forces for agglomeration (Redding and Venables, 2004).

Empirically, there is much evidence that infrastructure matters for trade performance within Africa. Alves and Edwards (2006) find that SA manufacturing exports are very responsive to improvements in rail carrying capacity and public-sector fixed capital stock of infrastructure. Paved roads, electricity generated and electricity, gas and water fixed capital stock also positively affect export performance, but to a lesser extent.

Cross-country studies of Africa find similar results, although there is disagreement on the extent to which improved infrastructure can enable African economies to diversify out of resource based products (Wood and Mayer, 2001; Elbadawi, 2001). Nevertheless, in most estimations, high transaction costs, particularly those related to infrastructure (particularly paved roads and telecommunications) and the business environment (including corruption) are shown to reduce exports, particularly of manufactured goods.

Improvements in trade facilitation are also found to have a large positive effect on trade flows in Africa and can often exceed the effect of lower tariffs (Wilson et al. 2003, 2005; Iwanow and Kirkpatrick, 2007).²⁶ Wilson et al. (2005: 864), for example, estimate that an improvement in port efficiency (port facilities and air transport) and the customs environment (hidden import barriers and irregular extra payments and bribes) in Africa to the world average, will raise export and import performance by between 1-5 percent, with the bulk of the gains arising from domestic rather than partner reform. The gains, however, are lower than in other regions including Latin America, East Asia and South Asia. Finally, improvements in trade facilitation are observed to at least triple the gains in welfare gains from a trade agreement between the Middle East and North Africa (MENA) and the EU (Dennis, 2006)

Quantitative measures of the magnitude of these sorts of barriers have already been presented in section 4.2. In order to get some sense of the potential gains in the SADC region from reducing barriers to trade other than tariffs, the simulations for the GTAPinGAMS model presented in Table 14

²⁶ Trade facilitation broadly includes elements related to port efficiency and customs administration, as well as 'inside the border' elements such as domestic regulatory environment and the services infrastructure to enable effective use of information technology (Wilson et al. 2005: 843).

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are rerun on the assumption that trade facilitation efforts and infrastructure investment reduce regional transactions costs by 25%. It is important to highlight that the GTAP data reflect primarily transport and handling costs. Burdensome administrative costs are much more difficult to detect. Hence the simulations capture only one aspect of deep integration.

The results are presented in Table 28. Reductions in transactions costs (as captured in GTAP) result in an additional nearly \$200 million in gains for the region as a whole on top of the gains depicted in Table 14. In other words, an increase in aggregate welfare of between 25 and 70 percent of the gains depicted in Table 14. In addition, while some regions capture relatively more gains than others, they are remarkably well distributed with every region gaining for every scenario considered. Details are not presented; however, the implications for factor prices are almost uniformly positive. Trade volumes increase, particularly for intra-SADC trade. The incremental impacts on revenue are negligible.

Table 28: Incremental gains from transactions cost reductions on intra-SADC trade.

	unif10	unif5	Zaf
Botswana	1.6	1.6	1.6
Malawi	0.6	0.6	0.6
Mozambique	0.7	0.7	0.7
Rest of SACU	1.2	1.2	1.2
Rest of SADC	0.2	0.2	0.2
South Africa	0.1	0.1	0.1
Tanzania	0.1	0.1	0.1
Zambia	0.6	0.6	0.6
Zimbabwe	0.3	0.3	0.3
Total (\$ million)	198.9	197.1	197.8

3.3. Policy coordination

The evidence presented above suggests significant gains from policies that foster *deep* integration, such as policies that improve infrastructure and reduce transaction costs. Other deep integration policies also matter. These include common rules and regulations on investment protection; standards; sales and excise taxes; and the use of industrial policy instruments and incentives. In reality, most existing customs unions have not got very far in harmonizing domestic policies. On the other hand, cooperation in these areas is crucial in strengthening regional development and credibility and reducing trade frictions and economic disputes.

The process and institutions for managing the CET is another area that will need to be addressed in deepening trade and industrial policy coordination in SADC. Changes in the CET must be agreed by all member countries, and sometimes, when economic interests are very divergent, this can act as a deterrent for future trade reform.

Finally, the use of duty exemption and rebate programmes is widespread in SADC and this will not only impact on the management of the CET, but will also affect the total value of duties collected and shared. The existence of export processing zones raises similar problems. There will need to be agreement on the use of rebates and all other exemptions from the CET.

SECTION G: DECIDING A MODEL FOR A SADC CUSTOMS UNION

1. Establishing the goals for a SADC Customs Union

In determining an appropriate model for a SADC Customs Union, it is important to go back to the overriding goals of member countries as reflected in the RISDP and Abuja Declaration. Commitments made in these documents foresee the Customs Union as a necessary step in the move towards a regional common market and eventually an African-wide Union. Good design is essential, but it must be 'design to achieve the objectives' set for the integration scheme. Since the term customs union can be used in a variety of ways, it makes sense to consider the range of objectives that can be set.

1.1. Is a CU an economic half-way house?

The sequence described in Section B and laid out in the RISDP suggests that a CU is a half-way house on the road from limited to full integration. On the one hand it implies that some substantial integration has already taken place: that tariffs and QRs have already been removed from trade between members (under an FTA). But more remains to be done after the CU is completed: it does not cover the wide range of other distortions to trade between them (standards, competition policy etc) and its common trade policies towards the rest of the world are similarly limited to tariffs and QRs. Moreover it is limited to the movement of goods: it does not cover either services or the movement of labour.

Such a progression implies that, for example, SADC cannot move to a CU until all tariffs and QRs have been removed from intra-regional trade. The mid-term review of the SADC Trade Protocol and the recently completed 'Study on the Implementation of the SDC Protocol on Trade' suggest that SADC still has some way to go in this regard.

But it need not be the only model; it is possible to envisage countries creating a CET *before* removing barriers to intra-regional trade. This is what Caricom have done. Such an alternative would allow SADC to proceed to the CU whilst some tariff and quantitative restrictions to internal trade were still being removed. There could be some merit in this. Once there exists a CET, for example, the rules of origin for intra-regional trade would no longer fulfil a role and could be abolished.

Regardless of whether the CET precedes or follows the full implementation of the SADC FTA, there could still be significant tensions within a CU arising from government interventions (i.e. subsidies or exchange rate policies) or because of mistrust (i.e. weak enforcement of external border controls in other countries). These are not dealt with by rules of origin and will not be removed by a CU; only deeper integration will deal with them.²⁷ Furthermore, the chosen method for collecting and distributing customs revenues will have a strong bearing on the efficiency of the CU and the economic gains from it.

This illustrates the tension that exists between the breadth and depth of economic integration. *Deep economic integration* might encourage producers to treat participating countries as a single economic space and concentrate their activities in a limited number of locations. Even deeper integration would help to facilitate the regional division of labour, thereby enabling more countries to participate in the dynamic gains from economic scale. If political integration does not move in sequence – harmonising the full range of policies that affect trade (on competition, subsidies, the exchange rate, movement of labour etc) - some members may feel that they are 'losing out' in terms of economic activity that is migrating to the most competitive locations.

²⁷ An obstacle to this 'alternative model' might be the WTO's Article XXIV which assumes that the countries creating a CU have already removed barriers to intra-regional trade. But, developing countries could aim to register their CU with the WTO under the enabling clause so that the disciplines of Article XXIV might not apply. It would be open for other WTO members to challenge this, which they might do if tariffs were generally raised (see above). But it is difficult to see what 'injury' they could claim to support a dispute if the CET were introduced (at an appropriate level) without the full completion of internal free trade.

1.2. Is a CU a political half-way house?

It is for such reasons that surviving custom unions are relatively rare, and efforts to create new ones usually progress slowly. Much analysis focuses on the EU, partly because there are so few other contemporary examples. Mercosur and the Central American Common Market (CACM) have achieved a CET that is substantially implemented, but have had their ups and downs, and the wider objectives of CACM remain largely unrealised. The Caribbean countries have been less successful: they committed to create a CU in 1973 in the Treaty of Chaguaramas and two decades later, in January 1993, they adopted a common external tariff (CET) for industrial goods – but not for agriculture, and with broad scope for exceptions and derogations. Moreover, the CET pre-dates internal free trade (in contrast to the idea that the six forms of economic integration form a progression). Only following the revised treaty in 2001 has there been the widespread removal of intra-regional *tariffs* (but not always other ‘tariff-like’ taxes).

Today, there are surprisingly few functioning customs unions but in the late nineteenth and early twentieth century there were many more. What tends to happen is that either an integration process which begins with economics moves on to politics and countries merge politically (as in the case of the Zollverein, for example, which was established in 1843, but disappeared with the creation of modern Germany). Or, attempts at CUs collapse under the pressures arising from unequal development within them (as happened in East Africa in 1977). The ‘open regionalism’ of East Asia and the Pacific can be seen as an attempt to avoid these two extremes.

The Southern African Customs Union (SACU) is an exception. Although fêted as the oldest customs union in the world, this is due partly to its failure to develop into fuller political union – for obvious historical reasons. In one sense, therefore, it is caught in a time warp: it recognises the economic inter-dependence of its members but their political independence.

Could it be that, having survived as a result of unique historical circumstance, the world has turned and SACU is now a model? The trend in the EU, for example, is now towards greater political independence (with the creation of sub-national legislatures in both Spain and UK in the very recent past). Is SACU’s combination of trade dependence and political independence rather ‘modern’?

But the key difference between what is happening in Europe and in Southern Africa is that the moves towards political autonomy in the former are taking place within the context of deep economic integration. The question SADC needs to answer is whether the autonomy re-emerging in Europe requires deeper integration (and whether this is desirable or feasible in the region) or whether a standard CU can be made more stable than many (though not all) of those attempted elsewhere. Is, for example, a common competition policy and standards an essential feature of any stable move to remove border controls? If so, is there the will to move so far, or can limited gains still be obtained from a CU-lite in which some border controls remain in place?

2. Making the choices

Selecting an appropriate model is thus a balancing act that must be executed ultimately in the light of the decisions that Governments take on the extent of the policy, fiscal and economic integration they wish to accept. This section provides a set of ‘questions’ designed to facilitate such decisions. They break down the task into its components. Each provides a short summary of the general issue which is then encapsulated in a SADC-specific question.

2.1. What are the non-economic goals for economic integration?

The tension arising from a CU (or any other form of regional integration) arises from the inherent *economic* purpose of the whole enterprise, which is to allow a group of states to gain the economies of scale and other benefits that accrue from a larger domestic market and, more importantly integrating more effectively with global markets. The reason the word ‘economic’ is italicised is because there can be other, non-economic goals of an integration scheme. These can be very helpful in maintaining momentum for economic integration particularly when it starts to ‘bite’ and economic activities start to move from one country to another. The EU illustrates this point very well – undoubtedly the strongest driving force behind the European Economic Community was the need to avoid further wars. The extent and commitment of SADC Governments to such non-economic purposes may be instrumental in determining the sustainability of some CU options.

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The question for SADC

Has SADC such a non-economic purpose? Can it be achieved more effectively via economic integration than through greater political co-operation? And are non-economic gains that might complement any economic gains and/or compensate for any economic costs that might be borne by some parties?

2.2. Should the CU precede full completion of the FTA?

The next three sub-sections are relevant if the answer to this question is that non-economic goals exist but that they are not sufficient, by themselves, to carry the SADC CU through all the tensions that normally arise in any integration scheme anywhere in the world. They deal with options for striking the right balance.

The 'normal sequence' assumes that the FTA occurs before (or at the same time as) the CU, but this is not the only model. Others things being equal, the combination of a regional FTA within a CU will produce greater economic gains than either of these alone – but it will also create greater tensions. Some of these tensions can be reduced if members agree to a CET before fully opening trade to goods produced in each other (some of which will include imported inputs).

The balance between the economic gains and adjustment pains of the two approaches depends on the production and revenue characteristics of the members. For example:

- if many members produce the same goods (and especially if some are trying to support the same infant industries) an FTA may create more tensions than a CU (which merely involves harmonising tariffs on goods many of which will be imported anyway since there exists a need that cannot be satisfied by domestic production);
- if most imports come from outside the regional group, then agreement on a simple and low CET may generate substantial welfare gains for most member countries and the CU might provide government's with a external motivation for implementing necessary trade reforms. But for those countries which are more dependent on tariff revenue than others, a 'harmonisation downwards' of their national tariffs to the CET may create more fiscal tensions than would result from an FTA.

The question for SADC

How do the production and revenue characteristics of SADC measure up to these alternative models? Which is more realistic at the present time: full completion of the SADC Trade Protocol and the finalisation of a CET by 2010, or maintenance of the *de facto status quo* on the Trade Protocol whilst the CET beds down?

2.3. Is a 'CU-lite' the most realistic option?

As well as considering the sequencing of the FTA and CU (and independent of the decision taken), Governments can assess how far they wish to travel immediately along the road to a 'classic' CU. There are various 'resting places' on this road that can be considered to explicitly deal with the possible loss in government revenue or industrial relocation that might arise from an economic union.

There can be *de jure* forms of variable geometry. These may be justifiable on the grounds that this will minimise *de facto* failures by members to implement provisions either in letter or in spirit (through the introduction of new trade barriers). Caricom, for example, has explicitly recognised a group of its members as 'lesser developed' economies that are entitled to additional methods of protection. The latter have replaced tariffs to intra-regional trade with other tariff-like taxes. Hence, despite agreeing a 'CET' the effective tariff-equivalent in these countries is higher than in the others.

Such approaches delay the achievement of the economic goals that the Customs Union was set up to deliver. But they may be a political necessity. And they may make it easier to reach agreement on technical matters such as revenue sharing (in this example because some members are able to levy 'top up' tariff-like charges).

The question for SADC

Will the rules of the SADC CU treat its less developed members differently from its more developed members? Will these differences extend to the application of different tariffs or quasi-tariffs to imports from outside the CU, and/or to imports from inside the CU? If so, how much economic gain will actually result?

2.4. Will 'redistribution-lite' be sufficient?

Many regional integration schemes include provision for a development bank and/or fund, one of the objectives of which is to provide additional finance to the poorer regions. The tasks of this bank/fund may be linked explicitly to the CU or not, but there is normally an expectation that the CU will involve some additionality of flows. The extra welfare created by integration provides the resources for this, and the adjustment costs the need for such measures.

But the countries reaping the gain must recognise the fact, there must be agreement on the scale of both the gains and the losses, and both must be reflected in a mechanism to ensure that the resources are made available. Under 'redistribution-lite' it is assumed that there is no direct transfer of revenue to common institutions. This avoids members having to deal immediately with the thorny issues of trust, decision-making and the relative competences of national and CU institutions that would otherwise be required.

In the absence of common institutions that 'own' them, these resources must be made available through special contributions from member states'. This can prove to be problematic. Caricom, for example, established a development fund that seeks to provide financial or technical support through loans, grants and interest subsidies. But it was introduced only in 2006 and has not yet been implemented. In the case of the EU, there is both the European Investment Bank and also, with much more clear re-distributive goals, the European Regional Development Fund and the European Social Fund. But the EU has its 'own resources' to pay for these.

The question for SADC

Will one or more member states be willing to fund a sufficiently large compensatory mechanism that it will overcome the tensions in the poorer countries caused by the movement of economic factors? Is the disparity in income between the richer and the poorer states sufficiently large, or are the anticipated gains sufficiently polarised to make such transfers realistic not just in the initial years but until the integration has moved to a deeper level? If so, then the additional complexities of 'regionally-owned resources' can be avoided.

2.5. Is 'redistribution-heavy' a realistic option?

If the answers to these questions are negative the economic tensions that economic integration necessarily creates may become too great with a redistribution-lite approach. But how realistic is it to move to the 'deeper' alternative rather than to a less onerous form of CU?

The EU is probably the most substantial and sustained example of redistribution-heavy. It is able to 'afford' a large *direct* redistribution because it has its 'own resources' – see Section C. And, in fact, the original creation of these involved a deliberate (and successful) attempt to create an even larger, *indirect* transfer mechanism.

There are two key features of this 'model'. The first is that the largest contributors to the EU budget are the countries that import most (especially agricultural products) and have the largest VAT base. The second is that expenditure is not influenced by the share of a country's trade, so there is no need for any accounting at borders within the customs territory. Goods originating outside the EU pay an import duty (and agricultural levied where appropriate) on initial entry which accrues to the EU budget; other countries have no direct financial interest in monitoring the subsequent passage of these goods across internal borders.

This contrasts to the situation in SACU which shares the first characteristics of the EU (that tariff revenue accrues to a joint institution of the Customs Union) but not the second characteristic (in that expenditure is also influenced by each country's share of imports). This provides a need to retain internal monitoring to check the movement of goods originating outside the customs territory across internal borders.

There are other differences. In the EU 'regionally owned' resources are not returned to member states (other than through the regional funds) – they are spent on common policies, most notably the common agricultural policy. This has been probably the most important re-distributive mechanism within the EU. An explicit objective of the creation in 1970 of the EU's 'own resources' was to lock the soon-to-be-enlarged community into a pattern of expenditure that benefited significant agricultural producing countries (notably, initially, France and more recently Ireland).

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For those countries that have benefited, the economic impact of this re-distribution has almost certainly been much greater than that of the direct transfers. Not only have the resources been substantial but they have also been providing directly to economic operators. The level of agricultural production in many parts of Europe is undoubtedly higher than it would have been without the CAP and, hence, so is the level of economic activity in quite a few. Agriculture has remained in place even though manufacturing has migrated to more central locations. But, at the same time, agriculture has become much more capital intensive and so whilst the economic activity has been retained, the employment has not.

The questions for SADC

Is SADC ready for all tariffs that are collected by members to be remitted to a common pool? To do so means that all members have sufficient confidence in the countries that collect most revenue (which are the coastal states) that they are willing to rely on distributions from the central pool in place of their own collections. And the main collecting states must either have confidence that they will receive a share from the pool commensurate with what they could collect independently or have sufficient non-tariff revenue (and sufficient interest in the success of the CU) that they are willing to accept a lower amount.

If so, is SADC willing to accept a redistribution formula that does not rely on members keeping a record of their imports of foreign-originating goods? If it is willing, it would be possible to achieve one of the main gains from economic integration, which is the reduction in transactions costs arising from the removal of internal border controls. If not, will there be real gains from regionally-owned resources?

Should payments from the common pool to members be limited to transfers direct to national treasuries or should some be used to fund regional policies? And should these policies be limited to those with a direct distributional objective (development funds) or include those with indirect distributional objectives (through support to productive activities)?

The list of these 'questions' is by far the longest of the five. This is because revenue sharing is a central issue: it must be addressed at the outset and it is fundamental to the type of CU that is desired. Section C identifies the technical possibilities. The final choice depends on the answers to the fundamental questions posed here, the technical characteristics of the options assessed in this paper and the indications from the modelling of the impact that the alternative choices will have on SADC economies.

SECTION H: RESULTS AND RECOMMENDATIONS

The previous two sub-sections spell-out the possible objectives and choices to be made by member countries in determining the shape and depth of a SADC Customs Union. A limited number of models or options are also described.

Our analysis indicates that deep and meaningful integration can generate important economic gains to the region and a CU can be an important vehicle through which to realise these gains. We therefore recommend that SADC economies continue to enhance and extend existing regional integration policies.

Identifying the appropriate form that this integration takes requires a political decision. The international experience confirms that no perfect model exists. Choosing the right model that best suits all of the countries in the region is the prerogative of Heads of State – but our Report can help by spelling out the implications of alternative decisions.

In what follows we highlight the main challenges confronted by SADC in deepening regional integration in Southern Africa and provide guidance on what should be done to make progress in each of these areas. Agreement in each of these areas is an important pre-condition to the establishment of a functioning and economically-beneficial SADC Customs Union.

1. The importance of open regionalism

The review of the international experience shows that there have been two stylised versions of CUs: one to create a single protected market sufficiently large to support infant industries – but we don't think SADC is big enough. The other, to break down barriers to trade both between countries and with the rest of the world – this could work for SADC but gains will be proportional to openness.

Our analysis shows that one of the primary economic benefits of SADC trade liberalization will be in its contribution to the international competitiveness of regional economies. Most SADC members are economically small. In terms of market size, all of SADC - including South Africa - is smaller than Turkey and several of the other smaller countries of Europe. SADC itself does not offer the scale of markets or the variety, quality and low cost of capital and intermediate goods necessary for local industries to compete without access to broader global markets.

While a decision to use a SADC Customs Union to increase or maintain barriers to trade with the rest of the world might help local producers aimed only at local markets, it will impede their ability to compete in the rest of the world. Furthermore, high external trade barriers together with reduced intra-union trade barriers will encourage costly trade diversion – replacement of low cost internationally sourced imports with higher cost regional goods – which will be especially harmful to smaller, less-developed SADC members.

Enhancing intra-regional trade alone is therefore a weak basis for the formation of the CU. The objective of the CU needs to be broader than the promotion of regional development through intra-regional trade. Our economic analysis shows that the CU can be effective in promoting development and welfare gains if it is used as an instrument to promote openness and integration into the world economy. The largest economic gains arise if the customs union leads to liberalisation of the external tariffs.

2. The importance of common institutions and policies

The international review describes a long list of common institutions and policies necessary for forming and managing a Customs Union. These include the establishment of a tariff board and associated procedures for determining a GET and participating in WTO mechanisms; procedures and documentation for harmonizing customs administration and trade and tariff data; and mechanisms for sharing revenues or managing common funds. There is no prescribed model on how this should be done and agreement on the appropriate structure and objectives of SADC institutions and policies will require careful thought and extensive negotiation.

3. The importance of a low CET

The level and structure of the agreed CET will have a strong bearing on the extent of trade diversion and the allocation of costs and benefits between member states. For the case of a single economy, the ideal tariff structure depends in considerable measure upon the structure of the economy. However, a customs union must consider multiple economies. The economies of SADC are characterized by a high degree of heterogeneity. Large variation is observed in nearly all important structural features: population, income per capita, other measures of socio-economic development (e.g., health status and literacy), infrastructure, structure of production, structure of trade, structure of government revenues, and structure of protection. Given this variation, *there is no possibility of designing a common external tariff that suits exactly the needs of each individual member economy.* This has implications for the choice of a common external tariff and the economic implications arising from this.

The analyses conducted and the existing literature from the region *strongly favor a low, flat, and broadly applied tariff structures.* These results indicate that, even though SADC member countries have the ability to design and implement their own tariff schedules, these schedules, in practice, rarely outperform a simple schedule consisting of a single low rate on intermediates and capital goods (setting the unique rate in the range from 0 to 5 percent, for example) and a single rate on consumer goods that is 5 percentage points higher. The available analyses point to considerably improved resource allocation and improved welfare region-wide as well as gains for most member states. Many of the welfare gains in the scenarios considered stem from the elimination of tariff peaks which would provide SACU, mainly South Africa, with considerable preference in SADC markets at the expense of imports from the rest of the world.

Four additional factors favor a common external tariff in general and tariff structures that are low and flat in particular over existing schedules. First, a simple external tariff structure may be the only way to accommodate the heterogeneity in the region. An attempt to formulate a CET that suits the different needs of each individual country will lead to a complex tariff structure with high variation in effective protection that is likely to impose large costs on individual economies.

Second, the adoption of a common schedule enhances the stability and credibility of the policy regime simply because a common schedule is very difficult to change. The advantages of policy stability and credibility are difficult to quantify but are widely viewed to be material, especially in terms of attracting investment.

Third, recent research indicates that evasion of tariffs and other border taxes is common in SADC economies with smuggled goods amounting to 25% or more of total imports in some economies. Furthermore, recent research finds that evasion is systematically related to the level and dispersion of tariff rates. Higher rates and higher dispersion in rates leads to higher rates of evasion with negative implications for revenue, the rule of law, and fairness.

Finally, importers can also avoid paying tariffs by seeking official exemptions. These are widespread throughout SADC. For example, in South Africa, actual tariff revenues are only about 56% of the level predicted by multiplying import volumes times the posted tariff rate. While some exemptions can be justified, many cannot be justified and all of them increase administrative burdens. A low and flat tariff schedule reduces incentives to seek official exemptions and opens the possibility for standardized policies to compensate exporters for the impact of duties applied to intermediate goods.

4. The importance of trade facilitation and reducing transactions costs

There is a large, growing and consistent body of international evidence suggesting that the gains from improved trade facilitation are large, with benefits at least equal to those of further tariff reform. Trade facilitation is a major problem in SADC, and attempts to improve it have been a major focus of SADC activity. Some of the problems arise from the nature of the FTA itself, and/or from its manner of implementation.

With each country operating its own customs area and with minimal coordination between them; with substantial differences in external tariff structures and resulting concerns about leakages of goods from low tariff or poor-quality enforcement regimes to countries with higher tariffs of better customs services; and with complex rules of origin made necessary by large tariff structure differences, border

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management is difficult and costly. This detracts from the basic goal of intra-SADC trade liberalization and enhanced regional economic integration.

While there are many ways in which trade facilitation can be enhanced within the framework of the current FTA arrangements, there is no doubt that creation of a common customs area through a SADC Customs Union could make a major additional contribution.

5. The importance of deep integration

At a minimum, the formation of a Customs Union requires agreement on a common external tariff structure and the removal of tariff barriers on intra-union trade. But there is a wide range of other areas in which improved policy coordination would be of great benefit. Reduced reliance on customs duties will lead quite naturally to a greater role for various kinds of sales and value-added taxes, a large share of which are also collected at each country's borders. Failure to improve coordination of these sales tax regimes could result in replacement of one form of trade barrier (customs duties) by another (sales taxes). There is a wide range of other areas, from competition policy, to standards enforcement and recognition and trade in services that have the potential to make a major contribution to the success of SADC economic integration.

The extent to which a Customs Union incorporates or deals with these 'deeper' issues has a significant effect on the size and distribution of economic costs and benefits. The benefits of deeper integration policies also depend on the extent to which they make the region more attractive to foreign, regional and domestic investment. Stable and predictable policies and institutions are good for growth.

6. The importance of revenue collection and distribution

The revenue impact analysis highlights the dependency of many SADC member states on customs duties as a source of government revenue. Given the paucity of revenue sources in most SADC economies, the option of substantially reducing revenue, forcing revenue replacement or expenditure reductions on a large scale, is not in the interest of most SADC economies for at least the medium term. The primary exceptions, South Africa and Mauritius, lie at the upper end of the income spectrum within SADC and are able to avail themselves of a greater range of options for raising revenue.

The CGE based economic analysis indicates that a simple external tariff structure with two rates (say 5% for intermediates and capital goods and 10% for consumption goods) would yield SADC-wide an approximately similar revenue value as is collected today. The curbing of evasion and exemptions will further enhance revenue collection. But whereas some countries (like South Africa and Mauritius) would gain, many of the poorer and land-locked SADC states would face substantial reductions in customs duties. Within SACU, the situation is further complicated by a revenue sharing formula, which currently provides for substantial redistribution from South Africa to Botswana, Lesotho, Namibia and Swaziland.

While the structure of government revenue and the lack of alternative revenue sources in SADC economies plays a key role in determining the average tariff and overall revenue levels, the pattern of trade in Southern Africa is key in determining an equitable revenue sharing rule. In most currently functioning customs unions, revenue is distributed on the basis of the destination principle. This would have two problems within SADC:

- The sharing of revenues on the basis of final consumption requires the maintenance of internal border controls and the strict enforcement of bond and transit arrangements. The costs of these arrangements greatly diminish the potential gains from regional integration.
- The destination principle strongly favors South Africa. A relatively high proportion of South Africa's imports come from the rest of world (with duties levied) and a relatively high proportion of South Africa's exports are destined for other SADC economies (where they enter duty free). The large majority of SADC members source a large share (many close to 50%) of their imports from South Africa and tend to export to non-SADC regions.

For both of these reasons, it will be necessary for SADC to adopt some form of revenue sharing arrangement whereby revenues are collected at the first point of entry into the customs union, and

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then redistributed to mirror the likely destination of the goods on which duties are collected. The key lesson from SACU is to keep this formula simple; and from the EU, is to provide some incentive to the country through which goods enter the Customs Union to actually collect revenues (the EU deals with this by allowing member countries to retain an agreed share of customs duties to cover administrative costs).

In addition to and separate from a 'neutral' revenue sharing formula, SADC will need to consider the establishment of a general development fund to support SADC-wide development projects and assist with adjustment in particular member states. This form of *redistribution-lite* will require commitments from the more developed members of SADC to provide most of the funding for a long-term regional compensation mechanism.

7. The importance of sequencing

It takes all customs unions a long time to progress from signature to a fully functional CU. The formation of a SADC CU in 2010 is likely to be the first in many steps towards deep regional integration and the breadth and pace of the CU will depend, in its early years, on agreement over key issues (such as a CET) and the readiness of different member states to implement these decisions. This is in line with the *CU-lite* or variable geometry option described in Section G. Whereas it may be relatively easy to adopt some instruments of regional integration, the determination of common policies and establishment of common institutions may take much longer. It is essential to develop and adopt realistic steps and timeframes to which individual member countries can then subscribe.

First among these should be the full implementation of the Free Trade Agreement; and the recently concluded 'Study on the Implementation of the SADC Trade Protocol' provides guidance on what needs to be done here. In parallel, discussions should begin on the determination of a Common External Tariff. This report provides guidance on key principles for a SADC-wide CET and a second study has already been commissioned on this topic. Finally, the unique position of SACU member states, which are already members of a functioning customs union, needs to be considered. Without substantial reform to the SACU CET and revenue sharing arrangement it is unlikely that SADC will be able to progress into a meaningful Customs Union.

To assist member countries in aligning themselves with the goals of the SADC CU, certain criteria may need to be set to determine which countries are eligible or able to join the Customs Union, and which are not. Based on the analysis presented in this study, full CU membership will require countries to accept a low and uniform CET; remove all tariffs and rules of origin on internal trade; and subscribe to an agreed revenue sharing formula. This would suggest that for member countries to subscribe to the Customs Union, the minimum first steps should include the full implementation of SADC trade protocol commitments and an agreement to withdraw from other regional organisations which have conflicting requirements.

8. The importance of coherency with other agreements

The problems posed by multiple Economic Partnership Agreements (EPAs) and overlapping memberships in other organizations are potentially acute from the perspective of the formation of a customs union. If SADC is to proceed towards a customs union, an integrated approach to the negotiation of the EPAs appears to be a necessary prerequisite. The scheduled date of 2008 for implementation of the EPAs implies some urgency in addressing the issue. If negotiated separately, the available evidence indicates that the agreements will establish highly differentiated tariff structures. The EPAs would then be completely at odds with the formation of a customs union.

9. The importance of a Customs Union?

Most of the economic gains from lower tariffs and improved trade facilitation do not depend on the creation of a customs union and there are substantial implementation challenges to be considered and addressed in moving from a Free Trade Area to a functional Customs Union. The adjustment costs may be considerable. It is for such reasons that surviving custom unions are relatively rare, and efforts to create new ones usually progress slowly.

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What additional gains might SADC achieve through a Customs Union, which cannot be attained through an FTA or unilateral reforms?

- First, negotiations on the CET provide an opportunity for governments to reform their own external tariffs. Lack of progress on multilateral liberalisation under the Doha Round implies that governments need to consider unilateral or regional trade reform as alternative mechanisms through which to enhance openness. Unilateral liberalisation is difficult, particularly if the economy is highly dependent on tariff revenue as a source of government revenue and established industries are effective in lobbying against tariff reductions. It is often easier to reform own tariffs within a region-wide initiative than unilaterally.
- Second, rules of origin remain a barrier to intra-regional trade under a FTA. These have been found to be highly restrictive in the case of SADC. Although the restrictiveness of these rules of origin can be reduced through unilateral liberalisation of intermediate inputs, this approach would need to be harmonised across all countries to be effective. For example, a policy of zero tariffs on inputs dispenses with the need for that country to impose rules of origin requirements on the products it imports from other SADC members. However, this policy accentuates the desire by its regional trading partners to enforce rules of origin requirements on exports from that country. Further, concerns over revenue loss and the diversion of goods under an FTA may limit the easing of stringent RoO. Without the impetus of a customs union and its revenue sharing formula, it is unlikely that the external tariff schedules of SADC countries will be similar and rules of origin and other admin/NTB issues will continue to absorb a considerable fraction of the gains from the FTA.
- Third, the CET “locks” countries into a regionally based tariff policy. Although this leads to a loss of autonomy to set trade policy by individual countries, the CET can enhance the stability and predictability of trade policy for the country and the region as a whole. This limits economically irrational trade policy by individual countries and also sends a clear signal to foreign investors who wish to deal with region as a whole.
- Finally, deeper integration policies may be facilitated if they occur under the common framework of a CU. Through participation in a CU, economies are forced to consider trade policy from a regional perspective, rather than from a unilateral perspective. This raises the incentive to deal with trade-related problems that are common to all countries, including regional infrastructure, standards, trade facilitation etc. For many of the smaller economies, the CU also gives an opportunity for these countries to adopt the institutions and policies of the larger more established economies. This enhances their own credibility with respect to economic policy.

Despite these potential gains, it is important to re-emphasise that extreme differences in economic development, trade flows and industrial policy within the region will pose considerable challenges to the formation of a SADC-wide Customs Union. If these challenges cannot immediately be overcome, then the gains from regional integration will be smaller than forecast and the likelihood of forming a functioning customs union much lower. This should not prevent progress in each of these areas. It is possible to achieve many of the economic gains from lower tariffs and improved trade facilitation through a well functioning FTA and this might prove an important first step towards the establishment of an open, efficient and predictable customs union in Southern Africa.

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Appendix A: Tables

Table 1: Distribution of GDP

	Agriculture (% of GDP)				Industry (% of GDP)				Manufacturing (% of GDP)				Services (% of GDP)			
	1980	1990	2000	2005	1980	1990	2000	2005	1980	1990	2000	2005	1980	1990	2000	2005
Angola	n.a	17.9	5.7	7.2	n.a	40.8	72.1	74.0	n.a	5	2.9	3.6	n.a	41.2	22.2	18.7
Botswana	11	4.6	2.4	2.3	45.1	56.4	58.9	53.3	5.3	4.9	4.4	3.9	43.9	39	38.6	44.4
DRC	25.3	30.1	50.0	46.0	33.1	28.2	20.3	25.3	14.3	11	4.8	5.5	41.6	41.6	29.7	28.7
Lesotho	24.6	23.4	18.6	17.3	26.5	33.7	41.1	41.4	n.a	n.a	16.8	18.5	48.9	42.9	40.4	41.3
Madagascar	na	na	28.8	27.9	na	Na	14.4	15.8	na	na	12.2	14.0			56.8	56.4
Malawi	43.7	45	39.5	34.7	22.5	28.9	17.9	19.4	13.7	19.5	12.9	12.5	33.7	26.1	42.5	45.9
Mauritius	12.4	12.1	5.9	6.1	25.9	32.2	31.2	28.2	15.3	23.6	23.7	20.2	61.8	55.7	62.9	65.7
Mozambique	37.1	37.1	26.1	22.3	34.4	18.4	26.6	29.8	n.a	10.2	13.3	14.2	28.5	44.5	47.3	47.9
Namibia	11.6	11.8	11.0	9.9	57.6	38.3	28.4	31.7	9.4	13.9	11.1	13.5	30.8	49.9	60.7	58.4
SA	6.2	4.6	3.3	2.5	48.2	40.1	31.8	30.3	21.6	23.6	19.0	18.6	45.6	55.3	64.9	67.1
Swaziland	23.7	13.7	15.5	11.5	32	43.4	44.8	47.6	22.3	35.9	35.8	36.9	44.3	42.8	39.7	40.9
Tanzania	n.a	46	45.0	44.5	n.a	17.7	15.7	17.8	n.a	9.3	7.5	7.5	n.a	36.4	39.2	37.6
Zambia	15.3	20.6	22.3	18.5	42.6	49.1	25.3	25.1	7.8	14	11.4	11.7	42.1	30.3	52.4	56.3
Zimbabwe	15.7	16.5	18.5	18.1	29	33.1	25.0	22.6	21.6	22.8	15.8	12.8	55.3	50.4	56.5	59.3

Source: World Development Indicators

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Table 2: World Bank Cost of Doing Business Indicators: Trading Across Borders

Region or Economy	Documents for export (number)	Rank (/171 countries)	Time for export (days)	Rank (/171 countries)	Cost to export (US\$ per container)	Rank (/171 countries)	Documents for import (number)	Rank (/171 countries)	Time for import (days)	Rank (/171 countries)	Cost to import (US\$ per container)	Rank (/171 countries)
East Asia & Pacific	6.9		23.9		884.8		9.3		25.9		1,037.10	
Europe & Central Asia	7.4		29.2		1,450.20		10		37.1		1,589.30	
Latin America & Caribbean	7.3		22.2		1,067.50		9.5		27.9		1,225.50	
Middle East & North Africa	7.1		27.1		923.9		10.3		35.4		1,182.80	
OECD	4.8		10.5		811		5.9		12.2		882.6	
South Asia	8.1		34.4		1,236.00		12.5		41.5		1,494.90	
Sub-Saharan Africa	8.2		40		1,561.10		12.2		51.5		1,946.90	
Angola	6	45	74	167	1,800	147	10	89	85	165	2,225	152
Botswana	6	45	37	136	524	22	9	66	42	130	1,159	84
Congo, Dem. Rep.	8	107	64	158	3,120	164	12	120	92	169	3,308	167
Lesotho	6	45	46	149	1,270	117	9	66	51	144	1,270	97
Madagascar	8	107	48	150	982	86	11	104	48	139	1,282	98
Malawi	8	107	44	145	1,565	134	16	157	60	150	1,590	124
Mauritius	5	20	16	49	683	37	7	34	16	39	683	27
Mozambique	6	45	39	138	1,516	133	16	157	38	119	1,616	125
Namibia	9	128	32	117	1,672	140	14	145	25	77	1,549	122
South Africa	5	20	31	116	850	70	9	66	34	104	850	50
Swaziland	9	128	9	16	1,857	150	14	145	35	109	1,950	138
Tanzania	3	2	24	91	822	66	10	89	39	123	917	57
Zambia	16	171	60	155	2,500	159	19	169	62	154	2,640	159
Zimbabwe	9	128	52	152	3,175	165	15	153	66	156	4,565	175

Source: <http://www.doingbusiness.org/ExploreTopics/TradingAcrossBorders/>

Notes: Cost is recorded as the fees levied on a 20-foot container in United States dollars. All the fees associated with completing the procedures to export or import the goods are included. These include costs for documents, administrative fees for customs clearance and technical control, terminal handling charges and inland transport. The cost measure does not include tariffs or trade taxes. Only official costs are recorded.

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Table 3: Indicators of infrastructure, governance and competition (score out of 7)

	Port Infrastructure Quality		Air Transport Infrastructure Quality		Irregular Payments in Exports & Imports		Business Costs of Corruption		Irregular Payments in Public Contracts		Favouritism in Decisions of Government Officials		Public Trust of Politicians		Quality of Competition in ISP Sector		Extent of Marketing	
	Score	Std	Score	Std	Score	Std	Score	Std	Score	Std	Score	Std	Score	Std	Score	Std	Score	Std
Angola	2.5	0.7	3.3	0.7	3.9	0.8	3.9	0.9	3.4	0.8	2.4	0.8	2.3	0.8	2.7	0.7	2.7	0.6
Botswana	2.7	0.7	3.8	0.9	4.9	1.0	4.7	1.0	4.2	1.0	3.6	1.1	3.5	1.3	3.4	0.8	3.6	0.8
Lesotho	1.9	0.5	2.2	0.5	4.0	0.8	4.1	0.9	3.5	0.8	2.9	0.9	2.2	0.8	2.7	0.7	2.9	0.7
Madagascar	2.3	0.6	3.2	0.7	3.9	0.8	2.9	0.6	3.2	0.8	2.8	0.9	2.2	0.8	3.3	0.8	3.5	0.8
Malawi	1.7	0.5	2.8	0.6	4.4	0.9	4.0	0.9	3.8	0.9	2.9	0.9	2.0	0.7	3.6	0.9	3.3	0.8
Mauritius	4.8	1.3	5.3	1.2	4.6	1.0	4.2	0.9	3.9	0.9	3.0	0.9	2.4	0.9	3.1	0.8	4.7	1.1
Mozambique	2.6	0.7	3.5	0.8	4.2	0.9	3.6	0.8	3.5	0.8	2.7	0.8	1.6	0.6	3.3	0.8	3.2	0.7
Namibia	5.0	1.4	4.9	1.1	4.0	0.8	4.1	0.9	4.0	0.9	3.0	0.9	2.7	1.0	3.2	0.8	3.8	0.9
South Africa	4.4	1.2	5.8	1.3	5.5	1.1	5.2	1.2	4.8	1.1	3.1	1.0	3.0	1.1	3.3	0.8	5.6	1.3
Tanzania	3.4	0.9	3.7	0.8	3.6	0.7	4.1	0.9	3.3	0.8	3.8	1.2	3.0	1.1	3.6	0.9	3.7	0.9
Zambia	1.9	0.5	4.6	1.0	2.3	0.5	2.5	0.6	2.7	0.6	2.2	0.7	1.6	0.6	2.1	0.5	2.2	0.5
Zimbabwe	3.0	0.8	2.6	0.6	3.5	0.7	4.0	0.9	3.1	0.7	2.2	0.7	1.3	0.5	3.1	0.8	3.8	0.9
SADC	3.0		3.8		4.1		3.9		3.6		2.9		2.3		3.1		3.6	
Average World (125 countries)	3.7		4.5		4.8		4.5		4.2		3.2		2.7		4.0		4.3	

Source: Global Competitiveness report

Notes: The column "Std" measures the ratio of the country measure to that of the World average.

Port Infrastructure Quality: Port facilities and inland waterways in your country are (1=underdeveloped, 7=as developed as the world's best)

Air Transport Infrastructure Quality: Air transport in your country is (1=infrequent and inefficient, 7=as extensive and efficient as the world's best)

Irregular Payments in Exports & Imports: How commonly do firms in your industry give irregular extra payments or bribes connected with import and export permits (1=common, 7=never)

Business Costs of Corruption: Do unfair or corrupt activities of other firms impose costs on your firm? (1=impose large costs, 7=impose no costs/not relevant)

Irregular Payments in Public Contracts: How commonly do firms in your industry give irregular extra payments or bribes connected with public contracts/investment projects (1=common, 7=never)

Favouritism in Decisions of Government Officials: When deciding upon policies and contracts, government officials (1=usually favour well-connected firms and individuals, 7=are neutral among firms and individuals)

Public Trust of Politicians: Public trust in the honesty of politicians is (1=very low, 7=very high)

Quality of Competition in ISP Sector: Is competition among your country's Internet Service Providers sufficient to ensure high quality, infrequent interruptions and low prices? (1=no, 7=yes, equal to world's best)

Extent of Marketing: The extent of marketing in your country is (1=limited or primitive, 7=high and among the world's most sophisticated)

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Table 4: Measures of protection by sector, SACU 2006

	Final good tariff	Input tariff	ERP final goods	ERP inputs	ERP all products
Agriculture	6%	2%	7%	1%	1%
Coal mining	0%	0%	-2%	-2%	-3%
Gold mining	0%	0%	-1%	-1%	-2%
Other mining	0%	0%	-1%	-1%	-1%
Food	12%	8%	51%	27%	38%
Beverages	3%	5%	0.5%	9%	1.1%
Tobacco	19%	14%	64%	45%	61%
Textiles	23%	15%	139%	76%	87%
Clothing	37%	20%	176%	75%	156%
Leather prods	28%	7%	155%	13%	75%
Footwear	29%	0%	153%	-23%	93%
Wood & prods	21%	3%	61%	5%	6%
Paper & prods	17%	2%	65%	3%	8%
Printing	0%	4%	-3%	7%	-2%
Petrol ref	0%	0%	1%	1%	1%
Basic chems	1%	2%	-1%	4%	3%
Other chems	2%	2%	2%	2%	1%
Rubber prods	8%	14%	35%	66%	64%
Plastic prods	16%	11%	50%	31%	35%
Glass & prods	4%	8%	6%	20%	16%
Non-met mins	24%	5%	76%	12%	16%
Bas iron & st	0%	2%	-5%	5%	4%
Bas n-fer met	0%	0%	-1%	1%	1%
Metal prods	17%	5%	58%	14%	19%
Machinery	12%	0%	40%	-4%	-2%
Electr mach	11%	5%	39%	11%	12%
Tv & coms eq	9%	1%	24%	0%	1%
Scientific eq	0%	0%	-4%	-4%	-5%
Motveh & parts	31%	26%	153%	117%	115%
Oth trnsp eq	2%	0%	5%	-2%	-1%
Furniture	18%	16%	51%	43%	44%
Oth industry	4%	2%	6%	1%	4%
Electricity			-1%	-1%	-1%
Water supply			-1%	-1%	-2%
Construct			-8%	-8%	-10%
Civil eng			-4%	-4%	-5%
Trade			-1%	-1%	-1%
Cat & accomm			-4%	-4%	-5%
Trnsp & stor			-4%	-4%	-4%
Communcat			-2%	-2%	-3%
Insurance & banking services			0%	0%	0%
Other business services			-1%	-1%	-1%
Med serv			-2%	-2%	-3%
Oth serv			-2%	-2%	-3%
Gen govt			-2%	-2%	-2%
GDP weighted averages					
All sectors	18.6%	6.5%	7.2%	2.9%	3.5%
Agriculture	5.6%	2.3%	7.2%	0.7%	1.2%
Mining	0.0%	0.0%	-1.4%	-1.4%	-1.8%
Manufacturing	18.8%	8.2%	41.1%	20.7%	24.6%
Services			-1.7%	-1.7%	-1.9%

Notes: HS 8-digit products are classified as Consumption goods (Final) or inputs (Capital and Intermediate goods) according to the Broad Economic Categories (BEC) classification available from UN Statistics. Passenger vehicles (BEC 51) are treated as both final and intermediate goods. ERP and export tax values are calculated using a SU table for 2002. The supply use table is deflated to world prices using the import weighted average tariff for each sector. In calculating ERP for final goods, we use the final tariff on outputs and the input tariff on intermediate inputs. For ERP input, we use the input tariff on both outputs and inputs. Tariffs include ad valorem equivalent for specific and mixed tariffs. Ad valorem equivalents are calculated using import prices for 2006. ERP for motor vehicles and parts include the 27 percent import rebate. Export taxes include estimates of the DCC, IRCC and 470.03. We use the average import penetration ratio for the sector to identify the domestic content of imports. This may bias our measure of export taxes upwards as exporters may use a more import intensive production structure than domestic producers.

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Table 5: Top 10 commodity exports to SADC

Malawi		Mauritius		Mozambique		SACU	
Description	Share	Description	Share	Description	Share	Description	Share
Corn (maize), other than	17	Diamonds, nonindustrial,	31.9	Electrical energy	44.1	Granules, iron or steel	7.4
Cane sugar, raw, solid fo	16.3	Woven cotton fabrics, den	7.9	Tobacco, not stemmed/stri	7.5	Mixtures odoriferous subs	6.7
Black tea fermdt & other	9.8	T-shirts, singlets, tank	6.8	Salmonidae, nesoi, fresh	5.4	Nickel ores and concentra	4.3
Cotton, not carded or com	6.7	Wheat or meslin flour	2.6	Shrimps and prawns, inclu	3.4	Refined fuel	4
Natural rubber in primary	3.4	Wov cot fab, unbl wea nes	2.5	Wheat or meslin flour	2.5	Refined copper cathodes a	2.6
Cotton seeds, whether or	3.1	Textile spinning machines	2.5	Cotton, not carded or com	1.7	Cane sugar, raw, solid fo	2.5
Men's or boys' trousers e	2.7	Printed books/brochures/l	2.2	New pneumatic tires of ru	1.6	Electrical energy	1.5
Men's or boys' other garm	2.3	Men's or boys' trousers e	2.1	Cotton seeds, whether or	1.5	Corn (maize), other than	1.5
Men's or boys shirts ot t	2	Looped pile fabrics of co	1.8	Refined fuel	1.3	Unused postage, check for	1.3
Plywood, ply nov6mm, both	1.9	Parts & accessories for a	1.5	Bran sharps & oth residue	1.3	Men's/boys' shirts of tex	1.2
TOTAL	65.2	TOTAL	61.6	TOTAL	70.2	TOTAL	32.9
Trade Value (US\$ m)	80	Trade Value (US\$ m)	34	Trade Value (US\$ m)	257	Trade Value (US\$ m)	8,125
Tanzania		Zambia		Zimbabwe		SADC	
Description	Share	Description	Share	Description	Share	Description	Share
Gold, nonmonetary, unwrou	32.6	Refined copper cathodes a	49.5	Granules, iron or steel	28.8	Granules, iron or steel	7.4
Corn (maize), other than	16.5	Cane sugar, raw, solid fo	4.4	Nickel ores and concentra	16.5	Mixtures odoriferous subs	6.7
Cigar/cheroot/cigarillo/c	4.9	Cotton, not carded or com	3.5	Unused postage, check for	4.9	Nickel ores and concentra	4.3
Wheat or meslin flour	4.3	Copper waste and scrap	3.5	Other, in coils, not furt	4.1	Refined fuel	4
Glass containers over 0.3	3.7	Cobalt and articles there	2.4	Asbestos	3.2	Refined copper cathodes a	2.6
Soap & oth orgn surf act	3.3	Copper wire, refined copp	2.3	Nickel, unwrought, not al	2.6	Cane sugar, raw, solid fo	2.5
Soap in forms nesoi	2.7	Tobacco, partly or wholly	2.2	Cane/beet sugar, refined,	2.6	Electrical energy	1.5
Oth furn art exc heading	2.7	Cobalt mattes	2.1	Tobacco, partly or wholly	2.1	Corn (maize), other than	1.5
Prec nesoi & semiprec sto	2.5	Tobacco, not stemmed/stri	1.9	Cotton, not carded or com	1.7	Unused postage, check for	1.3
Cashew nuts, fresh or dri	2.2	Electrical energy	1.4	Coke etc of coal, lignite	1.7	Men's/boys' shirts of tex	1.2
TOTAL	75.5	TOTAL	73.2	TOTAL	68.2	TOTAL	32.9
Trade Value (US\$ m)	77	Trade Value (US\$ m)	431	Trade Value (US\$ m)	2,098	Trade Value (US\$ m)	8,125

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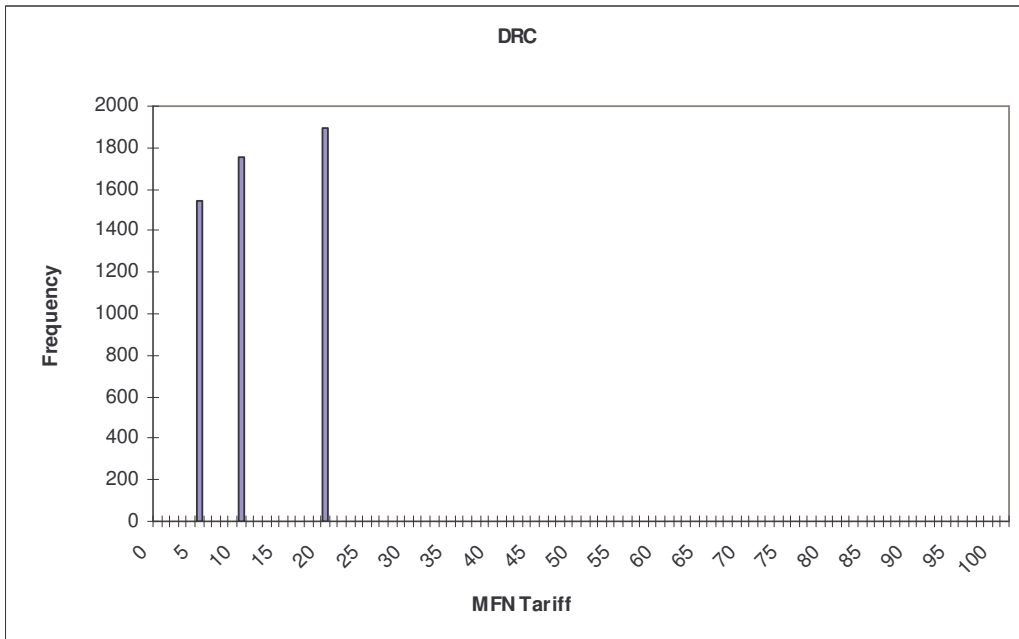
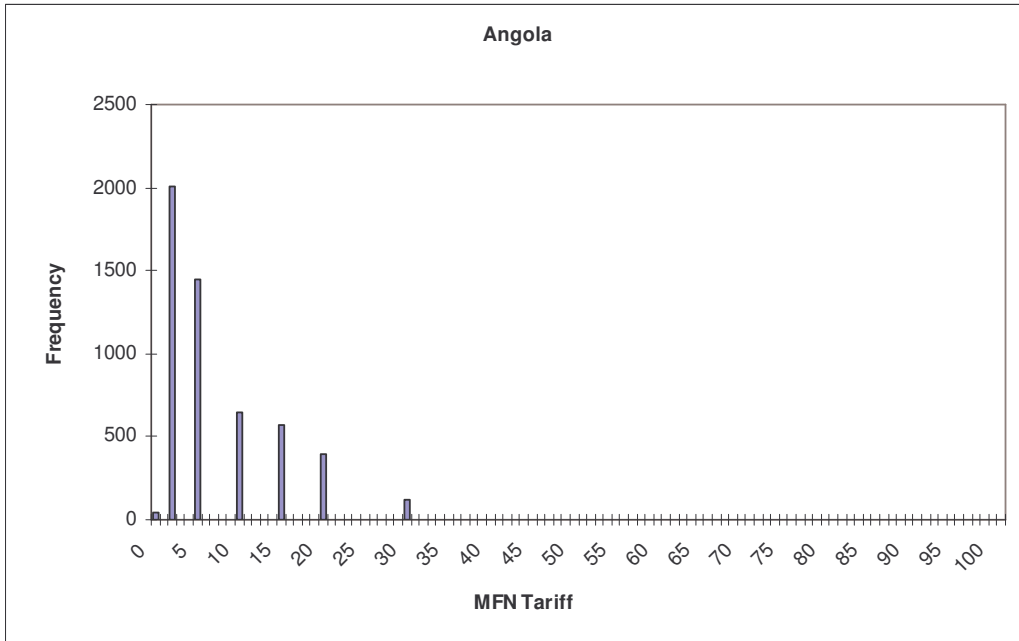
**Table 6: Finger-Kreinin Export similarity indices
(exports to SADC and ROW exports to SADC)**

	All products	Excluding fuel
Malawi	3.1	4.1
Mauritius	6.0	8.4
Mozambique	7.3	8.6
SACU	25.6	33.7
Tanzania	1.8	2.5
Zimbabwe	5.1	6.7
Zambia	4.6	5.1
SADC	15.8	20.1
SADC less SACU	7.8	9.7

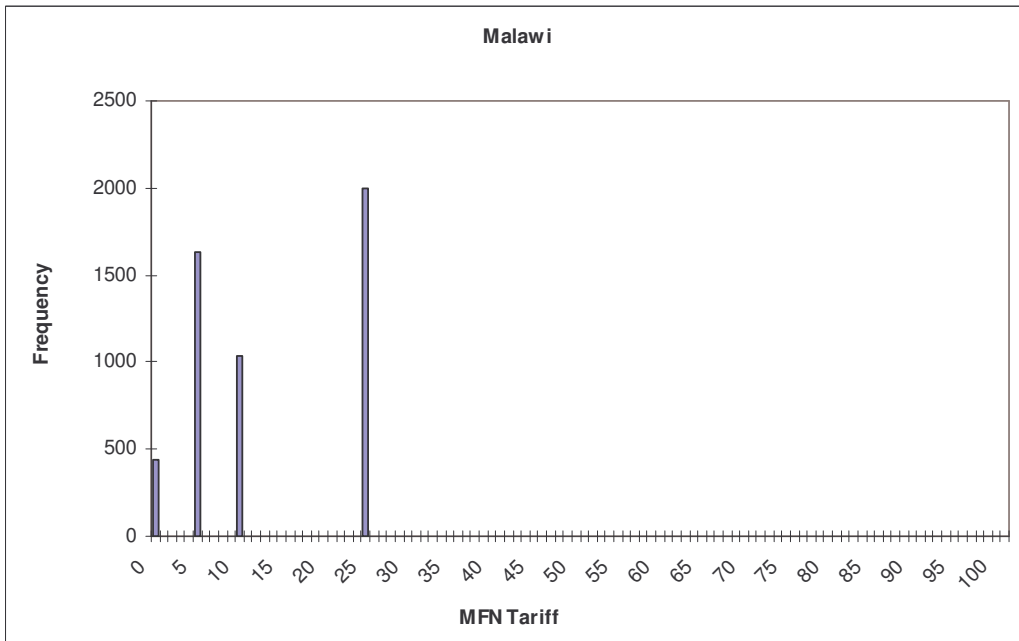
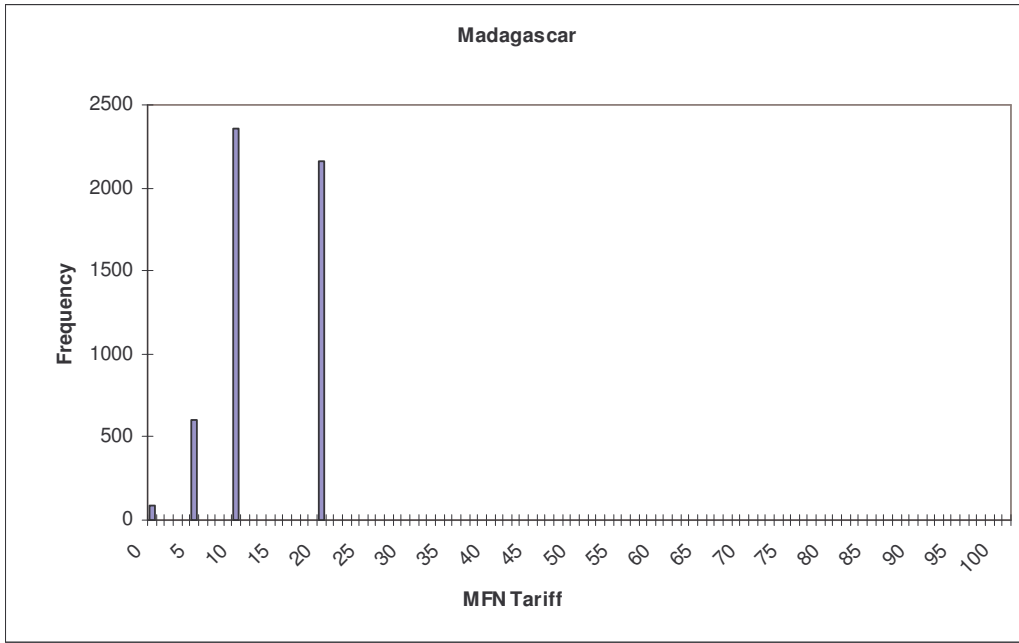
Notes: Based on Hs 6-digit data. The Finger-Kreinin index is calculated as

$\sum \min([X_{ia} / \sum X_{ia}], [X_{ib} / \sum X_{ib}])$ where i is product, a and b are countries and X is exports. The index ranges from 0 (dissimilar) to 100 (identical structure).

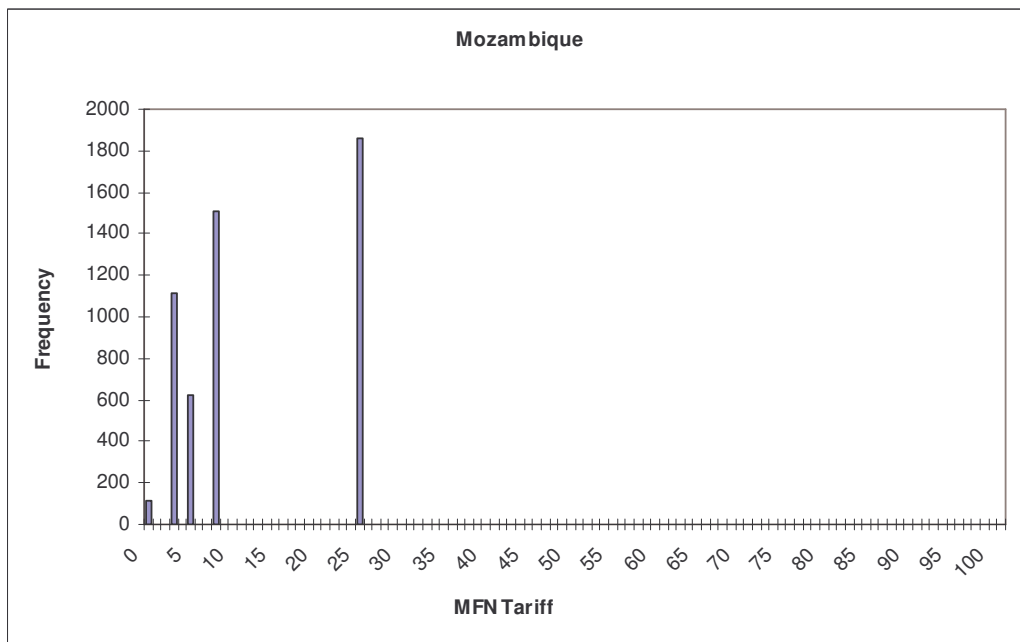
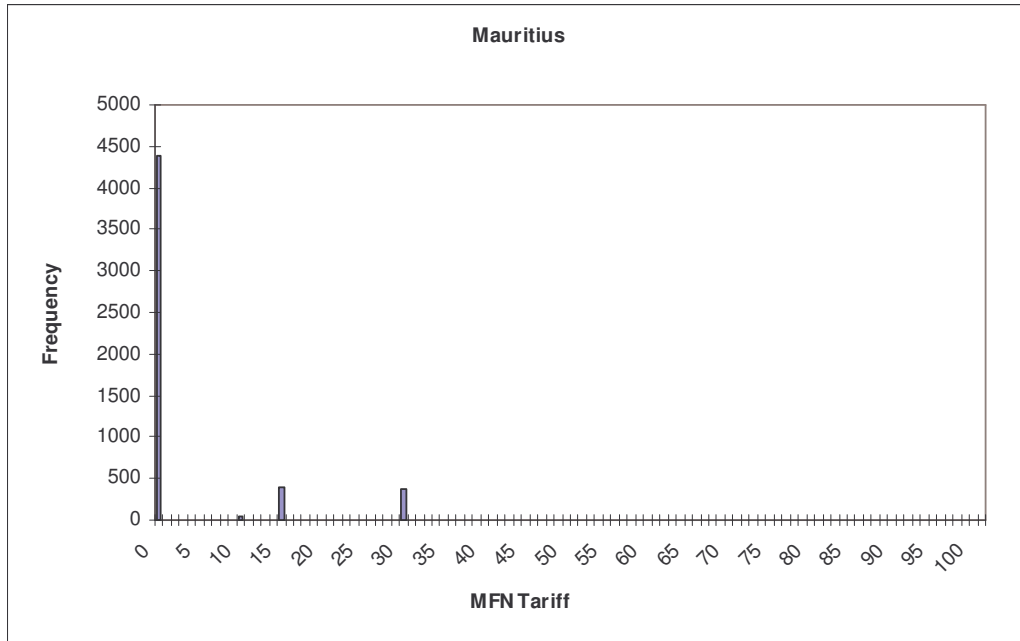
Appendix B: Tariff Schedules of SADC Member States



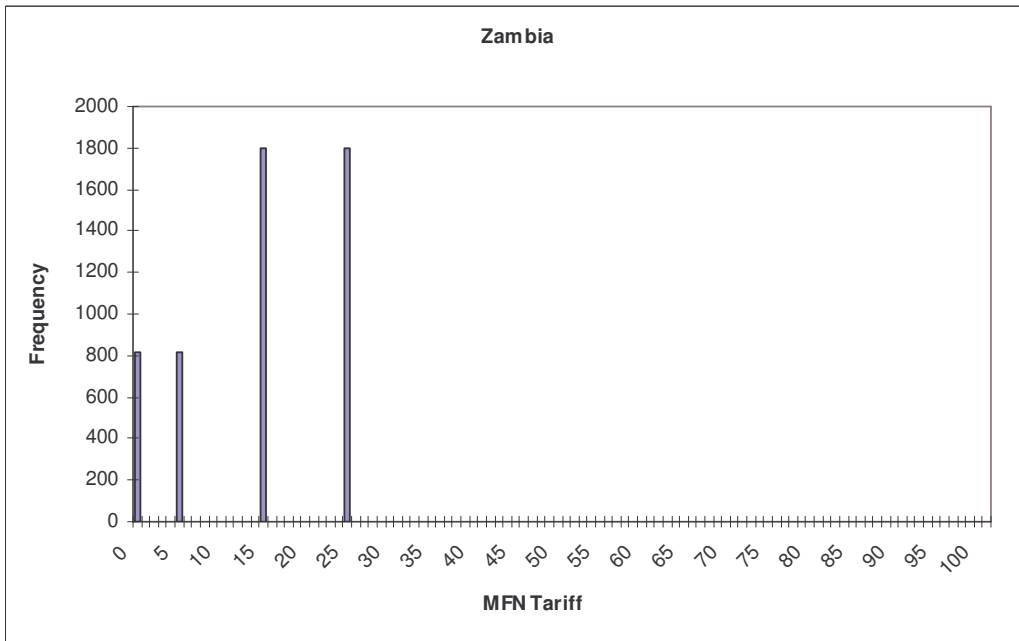
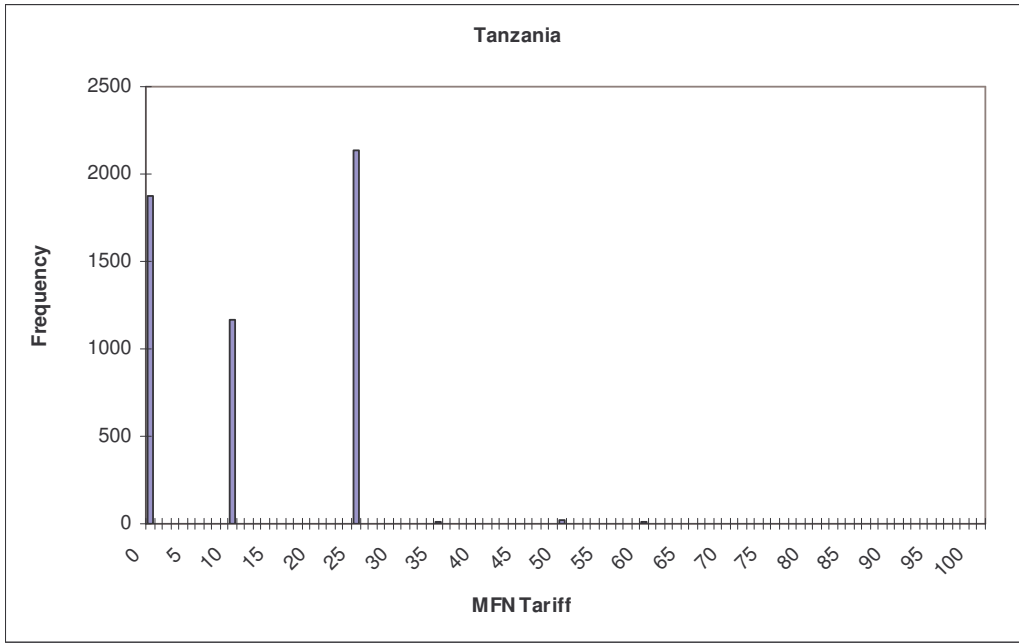
Evaluation of an Appropriate Model for a SADC Customs Union



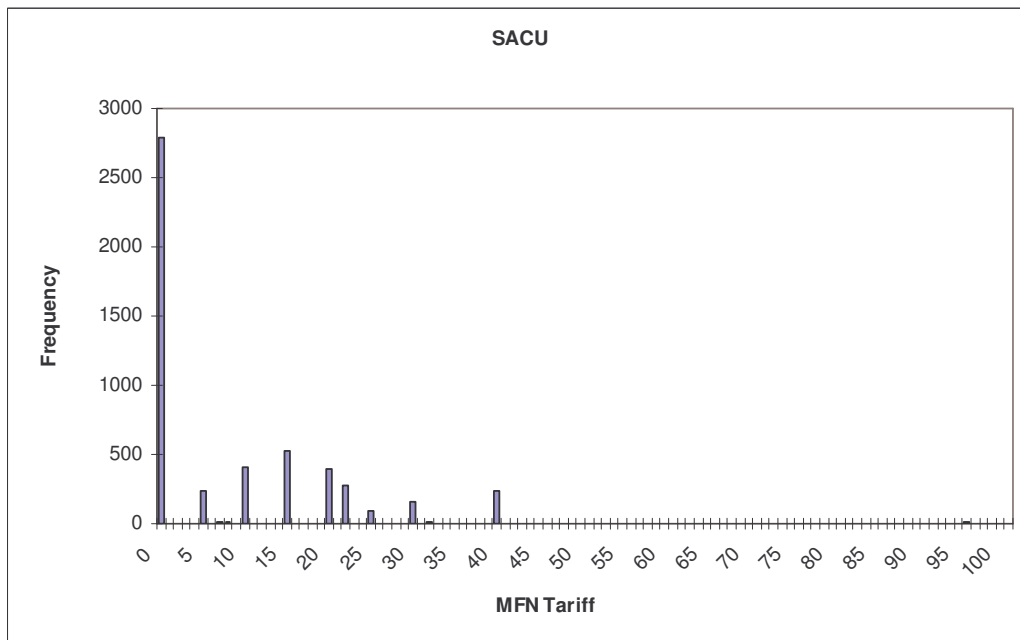
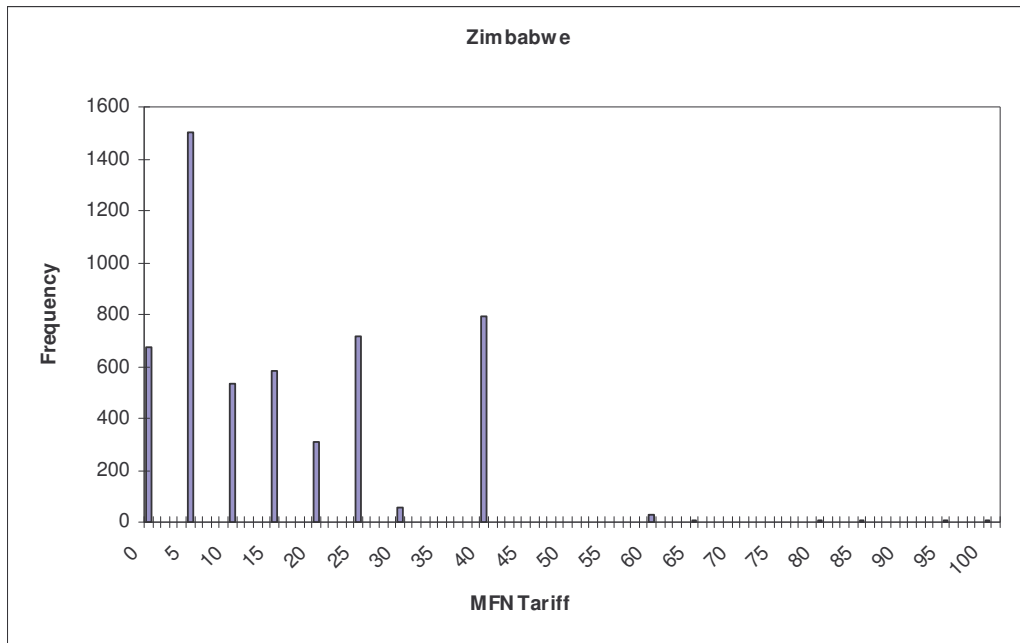
Evaluation of an Appropriate Model for a SADC Customs Union



Evaluation of an Appropriate Model for a SADC Customs Union



Evaluation of an Appropriate Model for a SADC Customs Union



Appendix C: CGE Methodology

The CGE model relies on version 6.0 of the GTAP database of global economic activity and a global economic model (GTAPinGAMS) developed by Rutherford (2005). Version 6.0 of the Global Trade Analysis Project database corresponds to the global economy in 2001 (GTAP, 2006) and provides the best available option for analysis of the SADC customs union as a whole. The database divides the world into 87 regions and 57 sectors and contains information on bilateral trade flows for all commodities between all 87 regions. The SADC region is included in the database, but is split into the following country groupings: South Africa, Botswana, Rest of South African Customs Union, Mozambique, Tanzania, Zambia, Malawi, Zimbabwe, and Rest of Southern African Development Community. Hence, not all individual countries are represented in the database. More details on database dimensions are presented in Table 33 below.

The GTAP trade data is unique in that it is fully reconciled so that global exports are equal to global imports. In addition to trade flow data, the database contains information, for each region, on protection (tariffs and other measures valued at tariff equivalent rates), household consumption, government consumption, investment, input-output relationships, and domestic direct and indirect tax rates. Finally, to facilitate trade modeling, the GTAP data provides econometrically based estimates of trade elasticities.

The GTAPinGAMS model is described in detail in Rutherford (2005). The model is essentially a series of regional computable general equilibrium models linked by trade flows. This model and variants thereof has been used to analyze a wide variety of trade related issues worldwide. A large number of applications are available on the GTAP web site. A few examples applications include Russia's accession to the WTO, implications of Doha trade round scenarios for Brazil, and regional trade agreements in Latin America with a focus on impacts on Chile.

Computable general equilibrium (CGE) models have served as workhorses for the analysis of trade policy reform because trade policy reform, particularly major reforms such as the formation of a customs union, is inherently multi-sectoral in nature. Changes in trade policy typically generate relative expansion in some sectors and relative declines in other sectors. The driving factors for changes in the structure of production and trade include (among other items) relative rates of protection across sectors and across countries both pre-reform and post reform, existing trade patterns and production structure, tax policy outside of trade policy, and macroeconomic policy (for example, if there are revenue losses from trade reform, how will these losses be accommodated?). The advantage of CGE models is that they capture these interacting effects and permit one to identify the major driving factors behind predicted changes.

Like any model, GTAPinGAMS is a simplification of reality that permits one to rigorously consider a vast number of possible policies and potential behavioural reactions by economic agents to policy shifts. The model is designed to aid decision-makers in the evaluation of alternative policy options. Although the model is based on country level data, and econometric estimates of elasticities, the results are not a prediction of the future. Rather, the global model is used as an "economic simulation laboratory" where the implications of alternative scenarios are considered.

Table 7: Dimensions of Data Set Employed in the GTAPinGAMS model

Regions:	Chn	China	Moz	Mozambique
	Jpn	Japan	Tza	Tanzânia
	Usa	United States	Zmb	Zâmbia
	Bwa	Botswana	Zwe	Zimbabwe
	Zaf	South Africa	Xsd	Rest of Southern African Development Community
	Xsc	Rest of SACU	Eur	European Union (15)
	Mwi	Malawi	Row	Rest of World
Factors:	Lnd	Land	Cap	Capital
	SkI	Skilled labor	Res	Natural resources
	Lab	Unskilled labor		

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Commodities:	pdr	Paddy rice	lum	Wood products
	wht	Wheat	ppp	Paper products, publishing
	gro	Cereal grains Nec	p_c	Petroleum, coal products
	V_f	Vegetables, fruit, nuts	crp	Chemical, rubber, plastic products
	osd	Oil seeds	nmm	Mineral products Nec
	c_b	Sugar cane, sugar beet	i_s	Ferrous metals
	pfb	Plant-based fibers	nfm	Metals Nec
	ocr	Crops Nec	fmp	Metal products
	ctl	Bovine cattle, sheep and goats, horses	mvh	Motor vehicles and parts
	oap	Animal products Nec	otn	Transport equipment Nec
	rmk	Raw milk	ele	Electronic equipment
	wol	Wool, silk-worm cocoons	ome	Machinery and equipment Nec
	frs	Forestry	omf	Manufactures Nec
	fsh	Fishing	ely	Electricity
	coa	Coal	gdt	Gas manufacture, distribution
	oil	Oil	wtr	Water
	gas	Gás	cns	Construction
	omn	Minerals Nec	trd	Trade
	cmt	Bovine meat products	otp	Transport Nec
	omt	Meat products Nec	wtp	Water transport
	vol	Vegetable oils and fats	atp	Air transport
	mil	Dairy products	cmn	Communication
	pcr	Processed rice	ofi	Financial services Nec
	sgr	Sugar	isr	Insurance
	ofd	Food products Nec	obs	Business services Nec
	b_t	Beverages and tobacco products	ros	Recreational and other services
	tex	Textiles	osg	Public Administration, Defense, Education, Health
	wap	Wearing apparel	dwe	Dwellings
	lea	Leather products		
