Implementing the SACU Revenue-Sharing Formula: Customs Revenues

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Introduction

SACU Member States have agreed to divide common customs revenues among themselves in an unusual manner—according to their shares of intra-SACU trade. Difficulties with obtaining reliable and mutually agreed data on this trade are posing serious and urgent implementation problems and have already caused serious conflict among Member States. This will only escalate without some immediate remedial measures. Some implementation difficulties were anticipated in the SACU Agreement and others appear to have received very little attention. Early experience in implementing the Agreement confirms that these problems are at least as difficult as anticipated and that their resolution will be very important to SACU's success in achieving its long run goals.

In addition to the administrative challenges of the new agreement, there are potentially serious trade and fiscal implications for all Member States. The economic effects of the new revenue-sharing formula have not been well recognized or discussed. Dealing with immediate administrative problems without an appreciation of their economic implications could produce solutions that are contrary to the interests of SACU and all its Member States.

The purpose of this brief is to discuss the administrative and economic issues underlying implementation of the revenue-sharing formula for customs revenues and to explore pragmatic solutions that will help solve immediate problems in a manner consistent with SACU's long term goals.

Background

Under both the old and new SACU revenue sharing arrangements the BLNS members have received a significant proportion of total government revenue from this source, and there is a considerable amount of implicit redistribution of fiscal revenues from South Africa to the BLNS. See Tables 1 and 2. South Africa, which accounts for over 90 percent of SACU GDP, receives only slightly more than half of the total revenue pool, and the revenue shares of the BLNS far exceed their shares of SACU economic activity.

Table 1: SACU Revenue Payments under the Old RSF, 2001/02

	Botswana	Lesotho	Namibia	Swaziland	South Africa
SACU Payment (R million)	2,622	1,438	2,641	1,503	9,897
% of Revenue Pool	14.5	7.9	14.6	8.3	54.7
% of Total Gov't. Rev. (excl. Grants)	12.8	51.0	30.4	54.1	3.9

Source: Derived from Customs Union Commission Reports

Table 2: SACU Revenue Payments under the New RSF, 2005/06

	Botswana	Lesotho	Namibia	Swaziland	South Africa
SACU Payment (R million)	4,008	1,984	3,228	2,795	13,027
% of Revenue Pool	16.0	7.9	12.9	11.2	52.0
% of Total Gov't. Rev. (excl. Grants)	12.1	48.6	25.1	68.5	3.4

Source: Rows 1 and 2 based on actual 2005/06 revenue shares; row 3 based on authors' estimates of Members' Government revenues.

Almost all of the implicit redistribution from South Africa to the BLNS under the new formula arises from the sharing of customs revenues. This is because the new formula allocates customs revenues, not on the basis of each member's imports of dutiable products, but rather in proportion to their shares of intra-SACU (i.e. non-dutiable) trade. Because of their small absolute and relative sizes, and their relatively low and undiversified levels of development, the BLNS have much higher propensities to import, from SACU (mainly South Africa) and the rest of the world than does South Africa. South Africa depends on the BLNS for only a very small share of its imports. Table 3 shows a comparison of members' shares of total imports and of intra-SACU imports.

Table 3: Members' Shares of Total and of Intra-SACU Imports

	Share of (1) Total Imports	Share of (2) Intra-SACU Imports	Ratio (2)/(1)
Botswana	4.9%	29.3%	5.9
Lesotho	2.5%	13.8%	5.6
Namibia	4.2%	23.8%	5.6
Swaziland	3.2%	21.2%	6.6
South Africa	85.2%	12.0%	0.1
Total	100.0%	100.0%	1.0

Sources: Column 2 based on final agreed numbers submitted by Member States for calculation of the 2005/06 revenue shares; column 1 derived from World Bank *African Development Indicators 2004.*

The old revenue sharing formula that was agreed in 1969 specified BLNS entitlements[1] to total customs duty and excise collections, and South Africa received the residual amounts. A 'stabilization factor' that was added to the formula in 1976 required that the BLNS each receive at least 17 per cent and at most 23 per cent of the value of their total c.i.f. imports (from all sources) plus excisable production inclusive of excise duties. Decreasing import duty rates resulted in the floor of 17 percent becoming the effective determinant of the BLNS revenue shares since 1980. The new floors ensured that the BLNS entitlements depended only on their shares of total imports and excisable production, independently of actual revenue collections. As the residual claimant, South Africa absorbed all the revenue impacts of changes in imports of the other members.

By the late 1990s, the BLNS Members' share was approaching half of the total revenue pool and by 2015, according to plausible estimates, their share would exceed 100 percent. Despite accounting for over 90 percent of SACU GDP and over 80 percent of SACU's total imports,

[1] Prior to 1990 this was BLS only.

South Africa was receiving less than 50 percent of customs and excise collections by 2004, and with no change in the revenue sharing formula this would fall to zero in about a decade. This was not sustainable and it was a matter of some urgency in the renegotiation of the SACU Agreement.

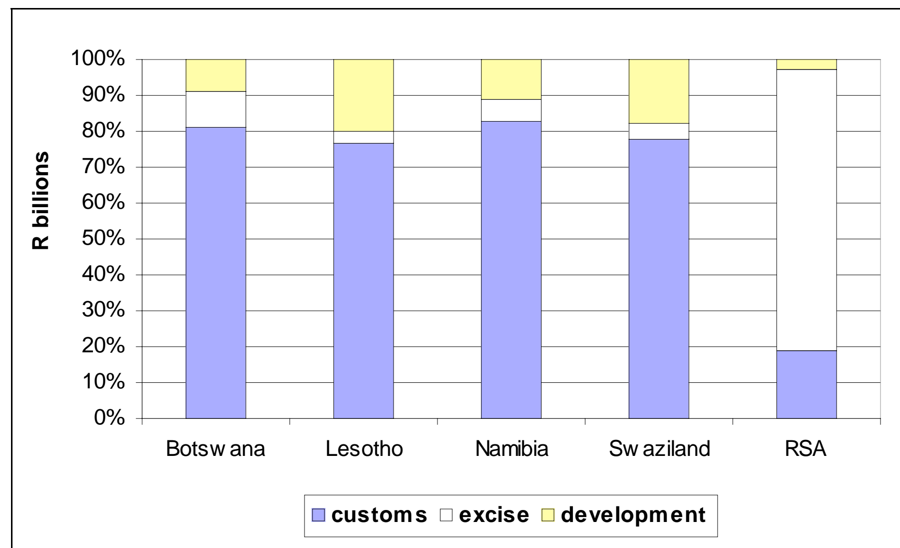
The new SACU agreement has made substantial changes to this revenue sharing arrangement.

The revenue share accruing to each member is now calculated from three basic components: a share of the customs pool; a share of the excise pool; and a share of a development component. These shares are calculated as follows.

- Customs revenue are distributed on the basis of intra-SACU imports.
- A development fund has been created from 15 percent of total excise collections, and is distributed equally among Member States with an adjustment of a small proportion of this total according to the inverse of each country's GDP/capita. As a first approximation, however, each Member State gets 20 percent of the development fund, which means that on a per capita basis, the BLNS get far more than much more populous South Africa.
- The remaining excise revenue is distributed proportionately to members' GDPs.

The net effect of this new arrangement is that South Africa retains about 50 percent of total customs and excise revenues collected, with the BLNS sharing the remaining 50 percent amongst themselves. But whereas South Africa receives about 80 percent of its SACU revenue through the excise component, the BLNS receive about 80 percent of their revenue from the customs component. This leaves them extremely vulnerable to fluctuations in the level of customs collections and their shares of intra-SACU trade.

Figure 1: Composition of SACU payment by component under the new RSF



The Problem

As partners in a customs union, SACU Member States levy a common external tariff on imports from non-members and impose no import duties on goods traded among themselves. Imports entering the union generally pay customs duties at the first port of entry, regardless of their ultimate destination within the union. Only a small portion of imports into South Africa and Namibia are shipped in bond to another Member State for Customs processing in the country of destination. *Therefore, few of the goods crossing a border between any pair of members need to be examined for customs duty purposes. This has the economic benefit, at least potentially, of significantly reducing transactions costs on trade within the union.* This is one of the primary purposes of any customs union. Article 1 identifies this as the first goal of the SACU Agreement (see Appendix II below).

As in any customs union, procedures have to be agreed for sharing common customs revenues. As indicated above, SACU has chosen a highly unusual method for doing this, i.e. to base Members' entitlements to the customs revenue pool on their shares of intra-SACU imports. Basing customs revenue sharing on trade which itself is not subject to any customs duties raises some serious administrative and economic issues.

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.* While statistics are often compiled from common administrative customs forms, there are wide discrepancies in the results reported by different Members. Without some solution to this problem, conflict is almost certain to increase. *An even deeper problem, not yet fully recognized, is the absence of a clear and mutually agreed definition of what is meant by intra-SACU trade.*

Are the data collection requirements of the revenue-sharing formula substantial? Would they necessarily impose significant extra costs on and impediments to intra-SACU trade?

The absence of import duties on intra-SACU trade means that there is no direct customs revenue need for monitoring intra-SACU trade. Nevertheless, there are many reasons why SACU Member States are interested in monitoring and/or keeping track of goods traded across their SACU and (if they exist) non-SACU borders. Trade data are an essential input into balance of payments statistics required for monetary, exchange rate and general macroeconomic policy management. Customs, agricultural and health officials need to monitor trade to control cross-border activities that are illegal or that might be dangerous to plant, animal or human health. VAT and sales tax administration requires information on imports and exports of taxable goods.

However, none of these functions requires that a distinction be made between goods that originate in another SACU Member State and those that come from elsewhere. It is only the SACU revenue-sharing formula that demands such a distinction. Furthermore VAT and sales tax administration, and protection against illegal or dangerous imports require monitoring of only certain subsets of cross-border transactions.

The data demands of the SACU revenue-sharing formula almost certainly impose a substantial additional Customs administration and compliance burden on intra-SACU trade. This increases the costs of such trade and frustrates one of the fundamental goals of the customs union. Conflict over current data has already proved to be a large and growing source of friction among Member States, a cause of uncertainty in fiscal planning, especially for BLNS members, and a significant administrative burden for all the members and for the SACU Secretariat. Continuing disagreement will escalate tensions and open further and heretofore unanticipated issues that almost certainly would cause even greater harm to Member States and to the further development of the customs union.

Data problems were foreseen in the drafting of the new SACU Agreement, and Annex A sets out procedures for dealing with some of the issues that were anticipated (see Appendix I below). These provisions have not succeeded in defusing conflicts.

The main sources of intra-SACU trade data at present are customs forms submitted when goods are imported and exported among SACU Member States. Lesotho, South Africa and Swaziland all use the same CCA1 declaration form. Botswana and Namibia require the use of a different form for their imports to and exports from other Members. SACU is in the process of moving to a different form (SAD500) that will require more information and that will meet the Botswana and Namibian coding requirements.[2] This should result in the use of a common form by all SACU Members in the near future. While this might help to improve consistency of different Members' trade estimates, it will not in itself solve any of the principal problems. Even in cases where identical forms are filed on both sides of a border, data on exports from one Member State do not generally reconcile with tallies of the same goods imported by the Member State on the other side of the border. Table 4 shows orders of magnitude of the discrepancies between import data reported by BLNS Members and export data for the same trade as recorded by SARS.

Table 4: Estimates of BLNS Intra-SACU Imports, 2002/03

	Intra-SACU Imports (R bn)		Excess
	(1) Reported by BLNS	**(2) Recorded by SARS**	**(1-2)/(2)**
Botswana	17.2	11.4	51%
Lesotho	8.1	5.0	61%
Namibia	13.9	10.9	28%
Swaziland	12.5	10.4	20%
South Africa	7.0	6.0	17%
Total	58.7	43.8	34%

Sources: Column 1 from SA Treasury and column 2 from SARS.

Discrepancies can arise for many reasons, starting with simple recording errors on either or both sides of the transactions. More systemic issues arise from differences in the treatment of temporary imports, from time lags in compiling and aggregating data and from the need to convert imports from *f.o.b.* into *c.i.f.* values. Another potentially significant issue is the treatment of unrecorded imports such as personal effects, goods crossing borders without customs posts and imports such as government purchases and diplomatic effects. Each Member State has a strong interest in estimating such import values in order to enhance its share of the pool.[3]

The most fundamental difficulty, however, lies in the incentive for each Member State to maximize its reported levels of intra-SACU imports. Each Member has a strong interest in taking advantage of each of the above-mentioned problems to adjust reported figures in an upward direction.

The magnitude of the resulting problem is indicated in another way by the data in Table 5, comparing reported values of intra-SACU imports and of total imports by SACU Member States.

[2] Botswana and Namibian Customs use different computer software than the other SACU Members.
[3] Discussions with Customs officials suggest that, at least in some Member States, they are keenly aware of the fiscal implications under the revenue sharing formula of being able to maximize reported import values.

Table 5: SACU Members' Intra-SACU and Total Imports

	Imports (R mn)		Ratio
	(1) Intra-SACU (2002/03)	(2) Total Imports (2002)	(1)/(2)
Botswana	17165	18434	93%
Lesotho	8073	9194	88%
Namibia	13943	15800	88%
Swaziland	12453	11977	104%
South Africa	7045	318272	2%
Total	58679	373677	16%

Sources: Column 2 derived from *World Bank African Development Indicators 2004*; column 1 from SACU Member States.

Table 5 compares intra-SACU trade data, as submitted by Member States for the calculation of 2005/05 revenue shares, to total imports as estimated and published by the World Bank, based on data provided by each country. While there are some methodological difficulties in making precise comparisons between these two data series,[4] it is quite remarkable that the BLNS import data show such a huge dependence of these countries on intra-SACU trade. Botswana shows intra-SACU imports equal to 93 percent of all imports from all sources, while Swaziland's intra-SACU imports appear to exceed total imports from all sources. The data provide a convincing illustration of the extent of the problem: realistically, no estimate of intra-SACU trade should come so close to any estimate of total imports.

There are two likely explanations for the apparently inflated intra-SACU trade data presented by the BLNS. First, it is generally accepted that intra-SACU trade data are weak. The South African Revenue Services acknowledges severe shortcomings in their own ability to collect and compare trade data between SACU Member States and are working towards improvements. This is likely to take some time. Different forms and Customs systems are used by different countries and there is no sharing of information across border posts.[5] There are also significant incentives for traders to over-report exports (to collect higher rebates) and to underreport imports (to pay lower consumption taxes). But this tax gaming incentive should contribute to *lower*, rather than *higher*, import data from the BLNS.

The second, and probably more severe problems arise from definitional issues. The SACU Agreement does not adequately define intra-SACU trade and this has enabled Member States to devise expanded interpretations. There are three main culprits.

- *Re-exports:* The Agreement's definition of intra-SACU trade explicitly excludes re-exports from one Member to another of goods originally imported from the rest of the world. However, there has been no attempt to define re-exports or to design mechanisms to account for them in estimating intra-SACU trade.[6] In practice, of course, it would be difficult and costly to do so. Consider, for example, the large number of South African-

[4] The intra-SACU data are provided in rands, using *c.i.f.* values and cover the financial year 2002/03; the World Bank data have been converted from dollars (using the average exchange rate for 2002 of 10.5) and *fob* (using a fixed margin of 10 percent) and reflect the 2002 calendar year

[5] Despite the many obvious advantages of such data sharing in terms of improved data quality and more efficient tax administration, the revenue-sharing formula gives each Member a strong disincentive to do so. Sharing data would reduce their ability to report higher import numbers, thus reducing their share of the revenue pool.

[6] The minutes of a technical committee meeting on 5 July 2001 made the following observations on this issue. "The technical team agreed, that as in the existing agreement, re-exports should be excluded from intra-SACU trade. Given the practical difficulties in implementing this principle (such as double counting), customs authorities were tasked to advise on an appropriate definition of re-exports within SACU. It was also agreed, that the IMF definition of re-exports would be obtained. All of this information would be provided to the drafting team prior to 10 July 2001." There has been no further progress on the issue.

based retailers that operate in the BLNS. Trade data reveal that large numbers of high-value consignments are exported from South Africa to the BLNS by Spar, Diskom, OK, Pep Stores and the like. It is extremely unlikely that these consignments contain only South African-made products. They almost certainly include extra-SACU imports, cleared in South Africa by South African retailers and agents, and then 'exported' from South Africa to the BLNS. The same is almost certainly true of machinery, building supplies, construction equipment, motor vehicles and components and many other goods imported by South African wholesalers and distributors and then resold throughout the SACU region. These would then be recorded, incorrectly, as intra-SACU trade. Stricter rules of origin and more stringent border controls might reduce the scale of this particular problem; but they would also defeat the overriding objective of SACU "to facilitate the cross-border movement of goods between the territories of the Member States." One of the fundamental advantages of a customs union over other free trade arrangements is the absence of any need for a rules of origin regime for trade among is members.[7]

- *Services:* Article 34 of the Agreement specifies that: " Each Member State's share of the customs component shall be calculated from the value of *goods* imported" (emphasis added). Despite the apparent exclusion of services from the definition of intra-SACU trade, at least some Members appear to have inflated import data by inclusion of certain services. For example, one Member State apparently includes significant electricity imports from South Africa in its intra-SACU trade data. This raises a number of immediate questions: why would SACU, as a customs union that excludes trade in services, share customs revenues collected on merchandise goods on the basis of services trade; how does one delimit the origin of services, such as electricity, to remove re-exports; should South Africa include its substantial water and labour imports from Lesotho; and how does one begin to reconcile, or even collect, trade data across the full range of traded services? To answer any one of these questions, satisfactorily, would be a major study in itself. Clearly, it is beyond the scope and spirit of the new SACU Agreement to even contemplate the inclusion of services trade, in the revenue sharing process.
- *C.I.F. conversion factor:* Whereas the SACU Customs valuations system is based on *f.o.b.* prices, the revenue sharing formula requires that intra-SACU trade be valued at *c.i.f.* prices. The absence of any agreement on how to make the conversion from *f.o.b.* to *c.i.f.* values has been another source of conflict and has led to a general inflation of trade values. As long as all Members engage in roughly the same degree of value inflation in this conversion process, the net effect on the revenue shares is minimal. But agreement on a general convention for making this conversion would certainly eliminate a needless source of conflict in the annual revenue allocation process.

At least the first two of these problems are very serious, and resolving them in a manner that is strictly consistent with the terms of the new SACU Agreement will pose a challenge to the operation of the revenue-sharing agreement.

It should be possible to agree on a definition of services and to exclude them henceforth from the basis for revenue-sharing. The resulting revenue reallocations might not be too severe.

The issue of re-exports might be much more difficult. The current practice seems to be for the BLNS to ignore re-exports. Intra-SACU trade is thus defined in two ways:

- For the BLNS it is defined as virtually all imports that arrive from or through South Africa or any other Member State. This accounts for almost the full value of all BLNS imports from all sources. There is no attempt to exclude re-exports of goods from non-Members that are cleared initially by South African Customs.

[7] For a review of some of the problems posed by rules of origin in SADC and other preferential trade agreements, see Brenton, Flatters and Kalenga 2004.

- For South Africa, intra-SACU trade is defined as goods imported from the BLNS, a very small share of her total imports. Since very few goods are re-exported from the BLNS to South Africa, the treatment of re-exports is not a real issue.

Taking proper account of re-exports would have a serious impact on the operation of the SACU Agreement. It would almost certainly require the implementation of a rules of origin regime that would be a source of continuing conflict and that would seriously disrupt intra-SACU trade. It would take away one of the principal advantages of a customs union. And it would produce a very different distribution of the customs pool, in favour of South Africa and at the expense of all the BLNS Members.

Any solutions to these problems would have to be undertaken in stages. The first stage would require some pragmatic resolution that could be agreed on a provisional basis. This would then give time to develop longer run solutions that are consistent with SACU's long run goals and that complement cooperation and economic integration in other areas.

Underlying Economic Issues

Underlying these "data problems" are some other systemic economic issues arising from the nature of the revenue sharing formula. Any short and longer run solutions to the implementation problems should be designed with these in mind and with the goal of reducing rather than aggravating them.

Fundamental Source of Conflict: In any given year, the customs pool is a fixed sum. Under the old formula South Africa was the residual claimant on the fund and so an increase in the revenues going to any of the BLNS members had no effect on the claims of any other BLNS member; South Africa bore all the adjustment. Under the current formula, an increase in intra-SACU imports claimed by any member reduces the revenue share of all other members. 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. Treasury and Customs officials in Member States are clearly aware of the budgetary significance of being able to report high intra-SACU import numbers and of the budgetary costs of high numbers claimed by others. Ambiguities and uncertainties in the data that form the basis of the customs revenue sharing are and will continue to be a natural source of conflict. This will not be helpful in developing economic cooperation and integration within the customs union.

Predictability and Stability: The BLNS members rely on the customs pool for a large share of their fiscal revenues. The predictability and stability (or lack thereof) of these customs revenues, therefore, are of considerable importance for budgetary planning in these countries. Unfortunately, intra-SACU imports are difficult to predict on an annual basis, and they are likely to be subject to large year-to-year variability. Furthermore, any single member's revenue share depends not only on its own intra-SACU imports, but also on those of all other SACU members. However easy or difficult it is for a country to predict its own intra-SACU imports, it is far more difficult to predict those of all other members as well. And even if a member knows that its own intra-SACU imports are relatively stable, this does not guarantee the stability of those of other members. Nevertheless, any single member's share of customs revenues depends critically on these factors.

Fiscal Redistribution and Sustainability: In the longer run, with continuing trade negotiations at the multilateral and regional levels, there can be little doubt that customs revenue will be of declining importance as a revenue source for SACU. Under the current revenue-sharing formula this will be of much greater importance for the BLNS, and especially its poorer members, than for South Africa. Table 6 shows some estimates of the declining share of SACU revenues in Members' GDPs as a result of trade liberalization arrangements that are already committed or currently under way. Since a major purpose of this part of the formula is to deal with a widely felt need for fiscal redistribution from richer to poorer Members, it might be fruitful to begin exploring some new approaches to this problem.

Table 6: Members' SACU Revenues, 1994-2020

	SACU Revenues as Share of GDP (%)				
	1994	2002	2005	2020(A)	2020(B)
Botswana	8.0%	4.5%	5.1%	2.1%	2.8%
Lesotho	28.0%	19.8%	21.5%	14.2%	12.6%
Namibia	7.7%	7.8%	8.1%	4.7%	4.4%
Swaziland	13.7%	12.9%	17.6%	10.3%	9.4%
South Africa	1.6%	1.2%	0.9%	0.8%	0.8%

Sources: 1994-2005, actual data; 2020, authors' estimates; 2020(A) assumes equal GDP and intra-SACU import growth of SACU Members from 2005 to 2020; 2020(B) assumes GDP and import growth of each Member continues at recent rates.

Customs and Trade Facilitation: Border tax collection is a key function of national Customs agencies. This imposes administrative and compliance costs on trade above and beyond the value of any taxes collected. These additional transactions costs can be substantial. A major intention and benefit of most customs unions is to eliminate this source of friction by virtue of the absence of customs duties on intra-union trade. However, by basing the division of external customs duties on the value of intra-SACU trade, SACU has made it much more difficult to achieve this goal of the customs union. In addition, as we have seen above, continuation of current conflicts over accounting for intra-SACU trade might eventually lead to even more troublesome and costly negotiation and implementation of a rules of origin regime.

Perverse Incentives for Trade Policy—Tariffs and Rebates: As already observed, the revenue shares of the BLNS are particularly sensitive to the total amount of customs duties collected. This raises serious issues and some perverse incentives regarding the fiscal impact of trade policy decisions. One obvious concern is that the BLNS might now be less willing to tolerate further reductions in SACU trade tariffs. This concern could be addressed through better information on the possible trade and welfare gains from tariff reform, and if necessary, compensation through adjustments to the development component. In the longer run, a more comprehensive review of alternative means of fiscal redistribution in SACU might be in order.

A more serious concern is that South Africa's existing and future duty rebate schemes are subsidized, disproportionately, by the smaller SACU member states.

Consider the (hypothetical) example of a R2 billion rand duty-rebate scheme for clothing and textile exporters (see Table 7). This would be small compared to the actual rebates already provided as an incentive for South African car exports. The loss in customs duties is borne almost entirely (88 percent of it) by the BLNS, but the resulting exports are enjoyed primarily by large South African producers. A simple MFN tariff cut would have the same revenue implications, but this could be weighed against the benefit of cheaper and better quality imports, some of which would be enjoyed by BLNS consumers. In the case of duty rebates, the BLNS carry most of the fiscal cost and must still bear the cost raising impact of tariffs on South African products as well as third-country imports. As long as the present revenue sharing formula remains in place, the review of the MIDP and design of any future rebate program should also address the possible revenue implications for the BLNS. The same arguments apply to rebate programs employed by other SACU Members. As table 6 shows, any BLNS Member would bear only 14 to 29 percent of the fiscal costs of any such measures under the current revenue sharing formula. Taking account of the fiscal externalities of

Members' rebate programs would be a difficult and highly contentious task that could be avoided by agreeing on a more effective mechanism for fiscal redistribution in SACU.

Table 7: Revenue Losses from a R2 Billion SA Duty Rebate

	SACU revenues (R mn)		%	%
	(1) Before rebate	(2) After rebate	Change	Share of revenue loss
Botswana	4008	3423	-15%	29%
Lesotho	1984	1709	-14%	14%
Namibia	3228	2753	-15%	24%
Swaziland	2795	2371	-15%	21%
South Africa	13027	12787	-2%	12%
Total	25042	23042	-8%	100%

Source: Authors' calculations.

Perverse Incentives for Trade Policy – Further Regional Integration: Whatever its shortcomings, SACU is still one of the most successful examples of regional economic integration in southern Africa. As a result, further expansion is a topic of real interest to SACU's existing Members and a number of other countries in the region. The new Agreement makes explicit provision for the entry of new Members. Unfortunately, the current revenue-sharing formula, at least as it applies to customs revenues, creates some very perverse incentives for Members in considering possible additions to SACU membership. The formula would encourage existing Members to resist 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. From a fiscal perspective, the formula makes the best candidates for new membership those that trade very little with the existing members (i.e. that would not claim much from the SACU customs pool) and that continue to import largely from the rest of the world (i.e. raise the size of the revenue pool). This is certainly contrary to the intention of SACU to promote regional trade and economic integration.

VAT and Sales Tax Administration: Except for implementation of the revenue sharing formula, the main fiscal reason for monitoring intra-SACU trade is to administer Members' separate VAT and sales tax regimes. All Members except Swaziland levy a VAT with rates of 10 percent (Botswana), 14 percent (Lesotho and South Africa) and 15 percent (Namibia). Swaziland imposes a retail sales tax at a rate of 14 percent. Zero rating of exports requires monitoring of exports from each Member, and the need to tax imports requires monitoring of imports from all sources. Even if this monitoring were done accurately and efficiently, it would not solve the data problems in implementing the revenue sharing formula. This is because: a) not all intra-SACU trade is taxable under the sales and VAT regimes, and b) VAT administration does not require any distinction between goods originating inside and outside of SACU.

In fact, there is very little coordination of VAT and sales tax administration across SACU Member States and this experience provides some lessons about administration of the revenue sharing formula. Separate border post administration by each Member and lack of basic information sharing provides obvious loopholes for tax fraud. CCA1 forms filed in the exporting country can show higher export values than the corresponding CCA1 forms filed in the importing Member. In the case of multiple consignments, the number of forms filed on the export side can be greater than the number filed on the importing side. Sharing of CCA1 forms would yield high dividends in discouraging this kind of fraud and would at the same time assist in reconciling estimates of cross-border trade, which is necessary for

implementation of the revenue sharing formula. However, as with the revenue sharing formula, heavy-handed efforts to improve data quality might come at the price of increased costs and hence discouragement of intra-SACU trade.

There are two ways in which VAT administration could be improved so as to reduce transactions costs of intra-SACU trade. The first would be to replace the separate Customs posts with a single border post at each crossing. All documentation and necessary monitoring would need to be done only once, with obvious savings in both administrative and compliance costs, and reduced opportunities for tax fraud. The second method would be to harmonize Members' VAT systems to eliminate rebates and taxes at SACU border crossings entirely, in effect taxing all intra-SACU transactions on an origin rather than destination basis, and reverting to the destination principle only when goods are imported into or exported from SACU. This would eliminate the need for border checks for VAT purposes, thus removing a major source of fraud and at the same time reducing barriers to intra-SACU trade. VAT revenues would then have to be pooled as is now done for excise and customs revenues, and distributed according to some agreed proxy for consumption of VAT-able goods in each Member State.

The Way Forward

A number of practical and economic problems have arisen from the new SACU revenue sharing formula, and in particular, the use of intra-SACU trade data to share customs revenues. These problems are closely inter-related and it is important that Member States do not lose sight of SACU's economic objectives when addressing some of the administrative obstacles to the implementation of the new Agreement. Critically, any long-term or interim attempt to collect or improve intra-SACU trade data should not be allowed to disrupt the free flow of goods between the member countries.

The 2005/06 revenue sharing process highlighted the extent of the differences in the data, systems and definitions used by Customs and trade authorities in the SACU member states. Customs authorities are working towards the harmonization of SACU Customs procedures and this should certainly take priority over data issues. Already, a single border post is being implemented with Lesotho, and by the end of this year, common customs forms will be used by most Member States**.** SACU revenue authorities should be encouraged to pursue border and tax co-operation in a way that facilitates trade.

In the short-term, it is extremely unlikely that Members will be able to reconcile intra-SACU trade data. And forcing revenue services to do so, for the sole purpose of a revenue sharing arrangement, is likely to frustrate the process described above. Instead, an expedient but interim solution should be found that satisfies the objectives and spirit of the new SACU Agreement; does not create conflict or confusion between the various revenue authorities; and does not interfere with intra-SACU trade. To get there, we would propose the following three steps:

1. *Get provisional agreement on key definitions:* SACU Members need to agree on what should or should not be included in any future calculation or estimate of intra-SACU trade. Services can and should be excluded. Re-exports should be excluded, but this is difficult to measure and enforce and should possibly be 'overlooked' in the short run. A common or accurate *c.i.f.* conversion factor should also be agreed.
2. *Get agreement on an acceptable ratio:* Once definitions have been agreed, at least on a provisional basis, and existing data in intra-SACU trade revised accordingly (i.e. services removed), it may be possible for Member States to agree on an acceptable historical ratio of intra-SACU trade. Two sets of data have been shared. The first formed the basis of the formula negotiations, and the second was used in the 2005/06 revenue sharing calculations. An average of the two might prove the best (and only) provisional estimate. That said, Members might have other ideas on how to agree on a fair distribution of trade, short of a lengthy (and possibly impossible) data reconciliation exercise. The current

problems are not simple "data issues" and any attempt to "improve" and "reconcile" different Members' trade data[8] will at best miss and quite possibly aggravate the main problems that derive from the economic incentives created by the current formula. Provisional agreement on some acceptable ratios would give time to re-examine the use and definitions of intra-SACU trade as a basis for fiscal sharing and redistribution in SACU.

3. *Agree to fix this ratio for an extended period of time:* A process is in place to harmonise customs systems and procedures throughout SACU. Rather than impose additional data burdens on this process, revenue authorities should be encouraged (mandated!) to complete this task. This will lead to better data over time. Meanwhile, the ratio agreed in the second step should be fixed and applied for an extended period, say 5 years. This will eliminate a key source of conflict between Member States and significantly enhance revenue stability.

Agreement on some provisional ratios will provide some breathing space that can free Members from the immediate conflicts and concerns that have arisen in implementing the revenue-sharing formula. This will help to improve economic cooperation and also give an opportunity at some later date to explore longer term means to improve fiscal harmonization and promote economic integration that will serve the mutual development needs of SACU Member States.

Among the matters that can be addressed in the longer term are the following.

- There is enormous scope for *simplification and harmonization of Customs procedures on intra-SACU trade*. This could begin with simple sharing of all Customs documents, but should move towards the establishment of single border posts at all crossings. This will simplify data collection, remove a major source of fraud in VAT and sales tax administration and reduce transactions costs in cross-border trade.[9] The longer run goal should be reduce all fiscally related border controls to the absolute minimum.
- *Intra-SACU trade might not be a viable long run basis for sharing customs pool*. First, the need to distinguish between intra- and extra-SACU trade poses implementation problems whose solution would require a costly rules of origin regime that would be a gross violation of SACU's goal of promoting trade among its Members. Second, a declining revenue pool might eventually make this a less viable means for achieving SACU's fiscal redistribution goals. *This is not necessarily an immediate problem, as long as some temporary accommodation can be reached on the treatment of re-exports.*
- *In the longer run, however, SACU should explore alternative means of achieving fiscal redistribution* among Members of widely varying fiscal capacities. The existing approach of basing customs revenue sharing and the majority of fiscal redistribution solely on intra-SACU trade is only a temporary expedient. Fiscal redistribution is an issue that faces almost all customs unions and federal states. SACU's Members should begin now to examine this wealth of international experience to find an approach that will work for SACU in the longer term, that will not require management systems that compromise the main goals of the union, that will not depend on arbitrary definitions, trade patterns and other fleeting circumstances, and that will accommodate rather than discourage increased fiscal harmonization and economic integration among its Members. Resolution of definitional issues regarding intra-SACU trade might lead to outcomes that are unacceptable from the perspective of the Members' goals for fiscal redistribution. Such problems could be avoided by using other means to achieve fiscal redistribution.

[8] A proposal submitted by CREFSA and currently under review by the SACU Secretariat and Member States is based on this mistaken notion that the current implementation problems can be solved through a technical data-cleaning exercise.

[9] This will not, in itself, tackle the difficulties in distinguishing between intra- and extra-SACU trade, as is required by the revenue-sharing formula.

- *Cooperation and eventual harmonization of VAT and sales tax systems* could contribute to the fiscal effectiveness of these important revenue sources while also promoting intra-SACU trade. This can start with simple information sharing, but should lead to the establishment of single border posts and, with complete harmonization, the elimination of any need for intra-SACU border controls for this purpose. Any improvements here will have additional short- and long-term benefits in the implementation of the revenue sharing formula.
- *The revenue-sharing formula provides perverse incentives in the design of tariff rebates and refunds.* Negative fiscal externalities imposed on other SACU Members reduce the costs to any Member of granting such rebates. Some combination of agreed disciplines on the use of such measures and compensation to other Members when they are employed would remove a source of future conflict and improve the design of future rebate policies.

These longer-term issues should not and cannot be resolved immediately. Reaching some provisional accommodation on implementation of the revenue-sharing formula is of much higher priority. This will have the additional benefit of taking some pressure off fledgling SACU institutions and cooperation mechanisms. As the capacity of these institutions improves over time and modes of cooperation improve, SACU will be better placed to make further steps that will increase economic integration and development of its members.

References

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Appendix I: Division of the Customs Pool as Described in the SACU Agreement

Annex A of the SACU Agreement provides the details of the calculation of members' shares of the customs pool as follows.

a) Each Member State's share of the customs component shall be calculated from the Cost-Insurance-Freight (CIF) value at border posts of goods imported from all other Member States into the area of each state as a percentage of the total CIF value of intra-SACU imports.

b) Each Member State shall submit the actual data of intra-SACU imports and intra-SACU exports, for the most recent financial year for which such data are available for all Member States, to the Secretariat at least six months prior to the beginning of any financial year. No future adjustments will be made for errors in or improvements to the trade data provided.

c) All import and export data provided for the calculation of these shares shall exclude the re-exports of goods imported from within or outside of the Common Customs Area.

d) All data will be converted to South African Rand value, using the average daily exchange rate for the financial year to which the data relate.

e) Where Member States are unable to provide actual CIF data, then the value of any enhancement factor used to calculate CIF values of imports from Free-on-Board (FOB) values of imports must be provided to the Secretariat and agreed by all other Member States.

f) If any Member State is unable to provide intra-SACU import data for the calculation of these shares, then the intra-SACU export data of other Member States shall be used to calculate its share. In such circumstances, Member States will agree on an enhancement factor to calculate CIF import data from FOB export data.

g) Where revenue forecasts for year (t) are used to calculate the size of the customs component to be distributed over the course of year (t), adjustments will be made in years (t+1) and (t+2) to account for differences between the forecast and actual revenue collected.

Appendix II: Goals of the SACU Agreement

Article 1 of the SACU Agreement sets out the following goals.

a) to facilitate the cross-border movement of goods between the territories of the Member States;

b) to create effective, transparent and democratic institutions which will ensure equitable trade benefits to Member States;

c) to promote conditions of fair competition in the Common Customs Area;

d) to substantially increase investment opportunities in the Common Customs Area;

e) to enhance the economic development, diversification, industrialisation and competitiveness of Member States;

f) to promote the integration of Member States into the global economy through enhanced trade and investment;

g) to facilitate the equitable sharing of revenue arising from customs, excise and additional duties levied by Member States; and

h) to facilitate the development of common policies and strategies.