SOUTHERN AFRICA GLOBAL COMPETITIVENESS HUB

Technical Report:

Implementing the SADC FTA: Where Are We? What Next?

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ACRONYMS

ACP	African, Caribbean and Pacific Group of States
AFTA	ASEAN Free Trade Area
AGOA	African Growth and Opportunities Act
ASEAN	Association of Southeast Asian Nations
AU	African Union
BLNS	Botswana, Lesotho, Namibia and Swaziland
BPO	Business Process Outsourcing
COMESA	Common Market for Eastern and Southern Africa
EAC	East African Community
EPA	Economic Partnership Agreement
EU	European Union
FTA	Free Trade Area
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
MFN	Most Favored Nation
NPV	Net Present Value
NTB	Non-Tariff Barrier
PTA	Preferential Trade Arrangement
RIM	Research in Motion
RISDP	Regional Indicative Strategic Development Plan
SACU	Southern Africa Customs Union
SADC	Southern African Development Community
TDCA	Trade, Development and Cooperation Agreement
UHT	Ultra High Temperature
US	United States
WCO	World Customs Organization
WTO	World Trade Organization

EXECUTIVE SUMMARY

Trade policy is one of many tools for improving productivity, increasing competitiveness and promoting long-term economic development. It is about far more than tariff negotiations. Similarly, SADC is about much more than implementing and extending the Trade Protocol. Great progress has been made; but much more could be done, in a much broader range of areas, to achieve more meaningful and productive economic integration—globally and in the region. Despite substantial reform at the Member State and SADC-wide levels, trade remains costly and continues to be hampered by well-intended initiatives whose unintended negative consequences for the region's development are insufficiently appreciated.

The Importance of SADC Integration

SADC is small; for most internationally traded goods regional markets are too small and fragmented to provide a base for globally competitive operations. To focus primarily on products in which firms rely on protection to compete locally and regionally is of limited value and is likely to point investors in the wrong direction. The focus must be on creating an environment in which investors can think about competing internationally. When this happens, SADC growth will accelerate and the SADC market will eventually merit real attention. But growth based on global markets must be the primary concern.

Regional integration works best if it is based on improving *global* competitiveness of regional products. It aims at reducing all impediments to trade within the region, while at the same time using this as platform for the similar removal of impediments to trade and investment with the entire world.

By comparison, ASEAN's markets are and have been much larger than SADC's. But its free trade area developed on the basis of integration of production networks with global markets. A substantial part of the trade in Southeast and East Asian is in intermediate products, with production divided among countries according to differences in their cost structures. This has helped the region to grow rapidly by improving its global competitiveness. This has not yet begun to happen in SADC.

A SADC Customs Union

The RISDP called for formation of a SADC customs union by 2010. This deadline will not be met. A SADC customs union, at least in principle, would reduce the need for intra-regional border controls, especially those related to enforcing rules of origin. Against this, however, must be weighed several considerations.

- Rules of origin are only one of many barriers to regional integration in SADC. Dealing with the other barriers is of great economic importance to the development of the region; and many of them can be dealt with independently of a customs union. Would negotiation of a customs union assist in dealing with these issues or would it serve instead as an unnecessary distraction?
- Based on experience to date, it would appear that a number of countries are simply not ready for a customs union, or even for complete intra-SADC free trade. A customs union in which members insist on imposing tariffs, quotas, bans

and other restrictions on intra-regional trade for economic development purposes would be futile, as would a union in which poorer countries are too dependent on customs revenue to contemplate reducing import duty rates. There are even more basic issues such as rules and guarantees on transit trade that can and should be dealt with long before a customs union or even completion of the SADC FTA.

- A customs union requires agreement on overall tariff policy—not only on common external tariffs but also on future preferential and MFN-based tariff negotiations as well as contingent protection such as antidumping and safeguard measures. SADC Member States are far from agreement on these questions. Mauritius plans to eliminate all MFN import duties and become a duty-free island. South Africa, on the other hand, sees import tariffs as a key tool of industrial policy. Agreement on a common tariff would require either undoing substantial reforms that have already taken place in some countries, or forcing others to move more swiftly on MFN tariff reform than they are prepared to do.
- Differences in approach to trade and economic development policy might make it difficult and maybe even inadvisable to move too quickly towards a SADC customs union. This is not necessarily a bad thing. Allowing for different approaches allows countries to experiment and to learn by themselves and from experiences in other SADC partners. A "lowest common denominator" approach, which might result from trying to move in unison towards a customs union at this time, could hold back more progressive and ambitious countries. Countries like Mauritius can help to "raise the bar" for all SADC Member States in setting policy targets for eventual deeper integration of tariff and other trade policies.

Is SACU a Model?

As the oldest customs union in the world, and one that includes five SADC Member States, SACU might be thought of as a model for a SADC customs union. However, a few points are worth considering first.

- In some respects SACU is a customs union more in name than in fact. The infant industry protection clause, for instance has resulted in the imposition of significant intra-SACU trade barriers in order to achieve industrial policy goals of questionable value, even for the countries imposing them. All intra-SACU imports are subject to complete customs control by each country, with intra-SACU trade being subject to inspection and documentation on each side of all borders.
- The revised SACU Agreement of 2002 called for joint decision-making on all MFN tariff decisions. Until now no SACU wide tariff body has been set up, and South Africa continues as *de facto* arbiter on tariff policy. The EPA negotiations revealed potentially serious differences among SACU members.
- The SACU revenue sharing formula is viewed by some SADC Member States, especially poorer ones, as a potential model for a SADC. This is primarily because it allocates a disproportionate share of customs revenues to the four smallest members. This is not replicable on a SADC-wide basis, nor should it even be thought of as a possible model. It is not replicable because South Africa would never agree to such massive redistributions on a wider basis. More importantly, the formula bases the distribution of customs revenues on non-

dutiable intra-SACU imports rather than on taxable imports from third countries. This makes it necessary to impose the very kind of intra-SACU border controls that are supposed to be made unnecessary by a customs union. Under the arrangement, definitions and measurement of intra-SACU trade have also become a source of conflict; and it is becoming apparent that the formula results in unpredictable and highly variable revenues for the BLNS, creating serious fiscal problems for at least the poorer of these countries.

There certainly are lessons to be learned from SACU. But it is unlikely to be an appropriate starting point or model for a SADC customs union, at least in its present form.

Performance Indicators for SADC

SADC conducts annual trade audits to monitor intra-SADC trade and implementation of tariff phase down schedules. Despite chronic weaknesses in the basic data, this has been useful. Examples and “case studies” from on-site visits to Member States have been valuable sources of information on how SADC is actually working. But this kind of investigation requires more resources than are needed for simple aggregate data analysis.

SADC has also undertaken a number of surveys of NTBs to intra-SADC trade. It has joined COMESA and the EAC in setting up a tripartite NTB reporting mechanism to enable the private sector to register complaints about NTBs in the region. This has revealed numerous NTBs across a broad range of sectors.

There has been considerable progress in implementing tariff phase downs; a number of countries have significantly reduced the incidence of NTBs and have begun implementing commitments on SADC-wide quality standards. Nevertheless SADC is far from meeting the goals agreed in the Trade Protocol of increasing tariff-free trade, reducing the number of NTBs and refraining from imposing new ones.

The approach to monitoring progress in SADC so far has been largely “legalistic”—focusing on the extent to which countries are meeting agreed liberalization commitments and finding specific areas in which new or improved negotiated commitments are necessary. Keeping track of progress in meeting official SADC policy commitments, of intra-SADC trade and of troublesome NTBs is important. But it is also critical not to lose sight of the broader purpose of SADC integration—it is part of a much larger project to improve productivity and competitiveness of SADC Member States so that they can integrate more effectively into the global economy.

Monitoring of intra-SADC trade and compliance with negotiated commitments might be complemented by a new and possibly much less “coercive” attempt to monitor progress in improving international competitiveness. Benchmarking success stories and identifying ways in which they can be extended and generalized could be very useful to all Member States.

This change of focus might lead to subtle and maybe not-so-subtle changes in the way that SADC institutions operate. At the risk of oversimplification, SADC appears to operate now at two different levels. At one level it is dominated by high level political visionaries guided by dreams of and plans for developing a greater southern

Africa and ultimately a more unified and successful African continent. On a day-to-day basis, however, it is dominated by trade negotiators, who see "concessions" on the use of tariffs, NTBs and other economic instruments as a surrender of sovereignty. They tend to view their main goal as to achieve openings in external markets. They do not see trade liberalization as part of a strategy to promote economic development by improving global competitiveness.

This is not uncommon. Trade negotiations are often driven by a mercantilist fiction, that imports are an evil to be avoided and that trade is a zero sum game.

In fact most of what trade negotiators deal in are issues that can best be resolved through domestic, unilateral trade policy reform. Most of what is needed to improve any country's business environment and international competitiveness can be done at home. It does not have to be "negotiated" with other countries.

Of course, pursuing domestic reform through international negotiations can be a way to overcome domestic resistance—from interests that benefit from barriers to competition due to restrictive trade policies. Maintaining the fiction that domestic reform is part of the price to pay for obtaining similar "concessions" by foreign partners can be a way to overcome domestic opposition to our own reforms.

For this to work, however, negotiators need to see through this fiction and recognize domestic reform as a means of enhancing development through improved competitiveness. Unfortunately, negotiators more often see themselves as representatives of domestic interests that might be negatively affected by trade reform; they see their main "stakeholders" as existing investors and producers that benefit from current trade restrictions, and not those that compete in world markets or future investors, producers, workers and consumers that will benefit from improvements in the business environment arising from trade reform.

This might be changed by some broadening of the focus of SADC itself—working together not so much to promote trade reform and trade negotiations as goals in themselves, but rather to identify and deal with the real constraints to growth. This does not necessarily require everyone to move at the same pace. Countries that wish to fast track certain reforms can do so, and in the process provide valuable information and maybe even a model to partner countries. Some issues will be more important and/or more amenable to change in some countries than in others.

This is not to denigrate past accomplishments or ongoing initiatives. It is to suggest, rather, the value of complementing past successes with a greater emphasis on monitoring and improving *competitiveness* in the region. A first step might be to complement annual trade audits and ongoing NTB monitoring with annual competitiveness audits. The purpose would not be to "name and shame" individual countries or to enforce negotiated agreements, but rather to highlight lessons that can be utilized by any Member and to identify areas and mechanisms for regional cooperation for the mutual benefit of the citizens of all Member States.

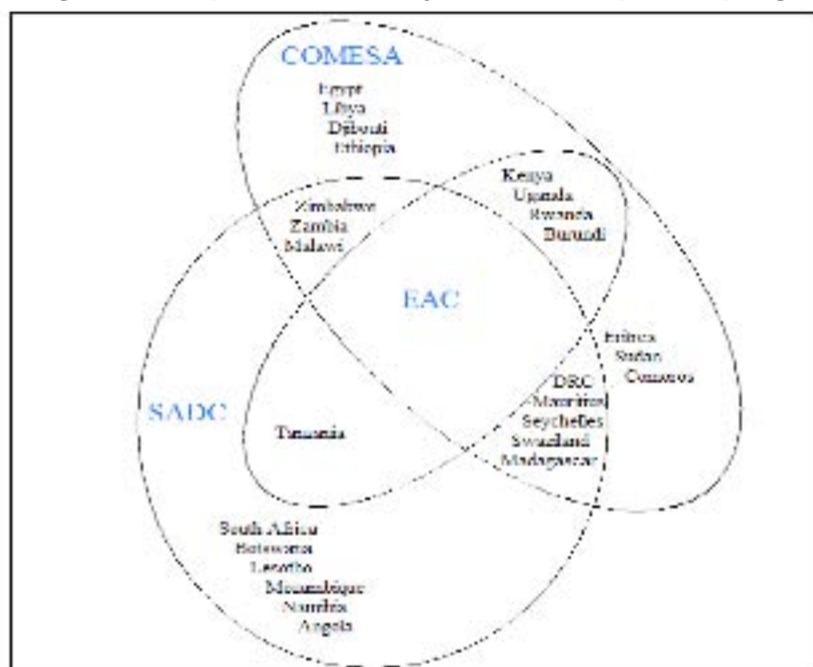
1. INTRODUCTION

The Southern African Development Community (SADC) Protocol on Trade was signed in 1996 and took effect in 2000; it has been in operation now for 10 years. Negotiations of the Protocol were informed by considerable internal and external discussion, research and assistance at the Member State and SADC-wide levels. Implementation has been monitored on an ongoing basis through a variety of mechanisms including a substantive Mid-Term Review (2005) and annual Trade Audits (starting in 2007).

In addition to the SADC Trade Protocol itself, SADC Member States are involved in a number of other preferential trade arrangements (PTAs). These include the Southern Africa Customs Union (SACU), the oldest customs union in the world, the Common Market for Eastern and Southern Africa (COMESA), the East African Community (EAC) and bilateral PTAs with other countries in and outside of SADC. Chief among the external PTAs are the Economic Partnership Agreements (EPAs) with the European Union (EU) and the (non-reciprocal) preferences in the United States (US) market that are available under the African Growth and Opportunity Act (AGOA).

SADC itself is still a work in progress. Among the important issues on the table are completing, fully implementing and deepening the current Free Trade Area (FTA), transforming the SADC FTA into a customs union, and merging SADC, COMESA and the EAC in a Tripartite FTA (see Figure 1), and eventually a pan-African FTA (African Union (AU) proposal). Pursuit of these agendas has also been aided by considerable research and a number of reports on strategies for pursuing the goals as set out by SADC Ministers.

Figure 1: Tripartite Country Membership Groupings



Source: The Tripartite Coordination Mechanism, “Draft Report on Establishing the Tripartite Free Trade Area” Nov 2009, p. 18.

This report is not an attempt to rehearse or repeat previous implementation reviews or strategic plans; rather it is intended to provide an assessment of where SADC stands at this moment in terms of the overall economic development challenges faced by its Member States. How do the Trade Protocol and other regional integration initiatives fit in with the broader goals of improving the prospects for economic development of these States and increasing the economic well being of their citizens?

2. BACKGROUND

SADC's Member States are diverse, in terms of both aggregate and per capita incomes. Overall, the region has been characterized by low levels and growth rates of per capita incomes, and relatively poor integration in the international economy. See Table 1.

Table 1: SADC Basic Economic Indicators, 2008

	GDP (mill. USD)	Population (millions)	Per Capita GDP (USD)	Per Cap GDP Growth (%)	Mfg Exports (% of GDP)
Angola	83,383	18.0	4,627	11.8	0.5
Botswana	12,969	1.9	6,808	-2.2	3.0
Congo, D.R.	11,588	64.2	180	3.2	NA
Lesotho	1,622	2.0	804	3.4	34.4
Madagascar	8,970	19.1	469	4.0	13.1
Malawi	4,269	14.3	299	6.9	2.9
Mauritius	8,651	1.3	6,818	4.7	13.7
Mozambique	9,735	21.8	447	4.5	0.3
Namibia	8,564	2.1	4,051	1.0	10.1
Seychelles	833	0.1	9,649	1.3	NA
South Africa	276,764	48.7	5,685	1.3	18.3
Swaziland	2,618	1.2	2,242	1.1	NA
Tanzania	20,490	42.5	482	4.4	0.8
Zambia	14,314	12.6	1,134	3.4	NA
Zimbabwe	NA	12.5	NA	NA	NA

Source: World Bank World Economic Indicators Online Database (6 September 2010).

SADC is economically small. Measured by total income (USD469 billion in 2008 according to World Bank statistics) all of SADC is smaller than Turkey, Poland or Sweden. This is too small on its own for firms to reap many of the economies of scope and scale necessary to compete in the global arena. Regional integration can provide some help in increasing market size for any individual Member State. But this will be of limited effectiveness if it is not accompanied by measures to improve their integration with the rest of the world as well.

Turkey, Poland and Sweden are each economically larger than SADC. But these countries recognize that a development strategy that focused solely on access to and competitiveness in only their domestic markets would be doomed to failure. Their economic success depends critically on their ability to integrate with Europe and broader world markets. This is why integration with Europe and the broader world economy is so important to them. In the same way enhanced regional

integration in SADC must be viewed in the context of its contribution, direct or indirect, to Member States' ability to increase competitiveness in world markets.

The Association of Southeast Asian National (ASEAN) Free Trade Area (AFTA) also provides lessons for SADC. AFTA was launched by its six core members in 1992.[1] It later expanded to include four less developed countries.[2] Like SADC, ASEAN includes countries of widely varying size and at very different levels of economic development. The ASEAN market, however, is far larger than SADC. The total Gross Domestic Product (GDP) of all ASEAN Member States in 2009 was USD1.5 trillion, more than three times the size of all of SADC. With such a large regional market one might have expected a major focus of regional trade to be on specialization to serve local and regional markets. While final consumer goods certainly have been an important part of intra-regional trade, the majority of trade in ASEAN is in intermediate products. ASEAN economic integration has been driven largely by regional and international firms wanting to utilize ASEAN as a production base to compete in global markets.

While SADC is economically small, it is geographically large. Distances are great and logistical infrastructure, both physical and institutional (or "hard" and "soft"), is weak and underdeveloped. This poses challenges to regional integration and to the development of international competitiveness. Unnecessary logistical impediments to trade shield local producers and consumers from import competition and reduce the competitiveness of local producers in external markets. By cutting off domestic markets from regional and global markets/competition, they can also contribute to a dangerous "inward-looking" approach to trade and industrial policy-making.

3. RECENT EXPERIENCE: AN OVERVIEW

Over the past two decades SADC Member States have made remarkable progress in improving economic integration among themselves and with the global economy. Not long ago several of them were embroiled in civil wars. South Africa, SADC's largest and most influential Member State, was politically and economically isolated in the region and in much of the rest of the world.

3.1 GLOBAL TRADE INTEGRATION

How far the region has come in a short period of time is illustrated by the case of South Africa. It would not require a drastic stretch of the truth to say that democratic South Africa was born out of autarky. The apartheid regime that preceded it was subject to sanctions on trade and investment with large parts of the world. Years of living under such conditions bred trade, investment and state enterprise policies based on self-sufficiency. "Strategic" industries were nurtured and protected; and the domestic economy was heavily regulated with wide use of price controls on basic commodities.

The political liberation that began in the 1990s gave birth to both the opportunity and recognition of the necessity to begin a major program of economic liberalization. South Africa embarked immediately on an ambitious program of tariff and trade

[1] The six charter members were Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand.
[2] These were Burma (a.k.a. Myanmar), Cambodia, Lao PDR and Vietnam.

policy reforms. This included major Most Favored Nation (MFN)-based liberalization through the World Trade Organization (WTO)—the elimination of quotas and most import surcharges and the replacement of most formula, specific and mixed tariffs with *ad valorem* duties. The tariff structure was also simplified through a reduction in the number of tariff lines and some reduction in the number of rates levied. From 1990 to 2004 import tariff rates were lowered substantially. The unweighted average nominal tariff (scheduled rates, including surcharges) fell from 22.9 percent in 1994 to 8.2 percent in 2004 (Edwards 2005).[3] This represents a substantial liberalization of trade.

As a result of these reforms, South Africa was rapidly reintegrated into the global economy. Shares of imports, exports and of inward and outbound investment grew substantially as a percentage of GDP. The economy became more open, more productive and more outward oriented. Export orientation and import penetration increased across both primary sectors and manufacturing. The greatest change, however, was in manufacturing where import penetration rose by 54 percent and export orientation almost doubled. Even more remarkable is the uniformity of this experience across all manufacturing sectors; export orientation increased in all except two of South Africa's 28 industrial sectors, and the same is true of import penetration.[4]

These are all signs of at least the beginning of a radical and highly successful economic adjustment. Whatever the reasons, and there can be no doubt that economic reform and the dropping of sanctions played a key role, the South African economy has become much better integrated with the global economy and has rationalized production in ways that respond at least in part to South Africa's relative cost competitiveness. This has happened not just between but also within sectors.

Despite substantial economic restructuring, however, South Africa's post-1994 economic performance has been less than might have been hoped for. In particular, export growth has been disappointing, and certainly less than might have been expected following such a deregulation of trade and other economic control measures.[5] While world export growth increased to 6.2 percent a year over the decade since 1994, South Africa's average export growth rate fell marginally to 5.6 percent, and the country's share of world exports has fallen from 0.7 to 0.5 percent.

The failure of trade reform to produce as much as might have been expected or hoped for has provoked considerable soul-searching and economic research. While there is far from complete agreement, a strong body of evidence suggests that one of the main reasons is that trade liberalization has been far less complete than might be thought.[6]

- The process of trade reform slowed to a crawl following the first wave in the mid-1990s. Further MFN-based tariff reductions are strongly resisted in some

[3] Cassim and van Seventer 2005 estimate that the unweighted average nominal rate fell from 17.4 percent in 1996 to 8.3 percent in 2004 and the import value weighted average went from 11.0 to 7.5 percent over the same period.
[4] Data in this paragraph are based on Dunne and Edwards (2006), Table 1.
[5] See Dunne and Edwards 2006, Flatters and Stern 2006b and Edwards and Lawrence 2006.
[6] See Flatters and Stern 2006a and a partial summary in Flatters and Stern 2007.

quarters, in part as a ‘weapon’ to be used in WTO negotiations. MFN tariffs in some “sensitive” sectors been raised in response to the global recession. The main focus of tariff reform in recent years has been PTAs.[7]

- The tariff structure remains complex.
- Decisions often reflect a product and sometimes even firm-specific approach to tariff policy, based on the claimed or perceived needs of individual firms. Tariff rates have continued to be negotiable, creating an incentive for rent seeking and a source of uncertainty for the majority of investors and producers.
- Despite considerable reductions in tariff rates, the made-to-measure structure of the tariff book has kept actual protection very high for many domestic producers. Many of goods actually produced in South Africa continue to have very high levels of effective protection and many have experienced increases in effective protection since 1994.
- For a time in the early part of this decade South Africa was one of the developing world’s most prolific users of WTO anti-dumping provisions, creating great uncertainty for producers and investors dependent on the use of products subject to such actions.
- There is growing evidence that the list of important impediments to trade and investment extends far beyond “traditional” trade policy instruments such as tariffs and quotas.

South Africa’s experience over this period is not unique in SADC. But her economic influence in SADC makes it especially important. Her experience is also not fully representative; countries like Mauritius have made bold and ambitious reforms of tariff and other trade policies in order to improve competitiveness and stimulate long term growth of income and jobs.

A critical question for SADC is how to make sense of and how to utilize the variety of SADC experiences in trade and development policies and how best to bring the lessons together in order to increase development prospects across the region.

3.2 REGIONAL TRADE INTEGRATION

Much of the focus of trade reform in the SADC region has shifted to the negotiation and/or further development of PTAs. Of most immediate interest to SADC Member States have been arrangements with developed countries in Europe and with the US, and PTAs among the Member States themselves, primarily SACU and SADC.

An early centerpiece for South Africa was the bilateral trade agreement (the Trade, Development and Cooperation Agreement (TDCA)) with the EU that was signed in1999 and came into full force in 2004. This agreement, especially its rules of origin, played an influential role in negotiation of the SADC Trade Protocol.

More recently, various groups of African, Caribbean and Pacific Group of States (ACP) countries (including all SADC Member States) negotiated their own reciprocal PTAs, known as EPAs with the EU. The so-called “SADC” group, however, comprised only SACU and Mozambique.

[7] See Cassim and van Seventer 2005, especially the discussion of section 5.

For countries that did not have reciprocal trade agreements with the EU (in SADC this meant every Member except South Africa) conclusion of an EPA was essential in order to maintain preferential access to the EU market for key exports that previously had benefitted from non-reciprocal preferences under the Cotonou Agreement. The urgency to conclude agreements before expiry of Cotonou preferences led several members of the negotiating group to sign EPAs without full agreement of other SACU partners, especially South Africa. Differences between South Africa's TDCA and the new EPAs, in particular with respect to rules of origin on textiles and clothing, as well as the more general inconsistencies arising from members of a customs union signing different trade agreements with an external partner aggravated other ongoing conflicts arising from operation of SACU itself.

Of similar importance to preferential trading agreements with the EU over the past decade has been AGOA under which SADC members and other African countries have been offered preferential access to the US market. Significant growth of exports and jobs in a number of SADC Members are directly attributable to AGOA. A relatively unrestrictive rule of origin in garments and textiles has been of great benefit to a number of countries that have qualified for use of this rule.

SACU, the world's oldest customs union, has been the pioneer of regional integration in the SADC region. It provides for a common external tariff and internal free trade among Botswana, Lesotho, Namibia, South Africa and Swaziland. It is regarded in some quarters as a possible basis for development of a SADC customs union.

SACU has undergone many changes since its inception in 1910. The most recent reforms were set out in a fundamentally new SACU agreement that was finalized in 2002. The key changes were a) to take away from South Africa the sole responsibility for customs tariff policy and replace it with a framework for joint decision-making by all Member States, and b) to reconfigure the mechanism for sharing customs union revenues and excise taxes. The new revenue sharing formula was designed to both ensure equity among SACU's members and, of special importance for South Africa, to remove a risk under the previous formula that South Africa might be responsible for distributing more revenues that were actually collected by the Member States. The new formula was based on the further assumption (at least by South Africa) that customs revenues would gradually diminish in relative importance as a revenue source.[8]

Delays in establishing new tariff making institutions, large unexpected increases in customs tariff revenues arising from rapid growth of a few highly taxed imports (especially motor vehicles and garments) which resulted in large unexpected increases in revenue transfers to Botswana, Lesotho, Namibia and Swaziland (the BLNS members), and then disagreements and conflicts arising from the EPA negotiations have created serious conflicts among SACU Member States and might even threaten the future of SACU itself (Flatters and Stern 2005, 2006b).

[8] See Kirk and Stern 2003 for more on the background and rationale for the new agreement.

The other focus of regional integration, of course, has been SADC. SADC's schedule for economic integration was defined in the SADC Trade Protocol, which sets the terms for the elimination of import duties on almost all intra-SADC trade according to differential implementation schedules. SACU agreed to reduce its rates at a faster pace than other members, but full implementation by all members was to be completed by 2012. Implementation of the Trade Protocol was to be supported and extended through identification and elimination of non-tariff import barriers (NTBs), cooperation in a wide range of other measures ranging from customs to common transit shipping rules and agreement on and implementation of rules for recognition of standards. According to the Regional Indicative Strategic Development Plan (RISDP) the free trade agreement eventually would be broadened into a full customs union by as soon as 2010, a common market by 2015 and a monetary union by 2016.

3.3 TRADE PERFORMANCE

SADC regional trade data are poor. Based on existing data, however, it appears that there has been some increase in intra-regional trade over the past decade or so (DNA 2007). Over a longer time period, since the 1980s, intra-SADC trade has grown significantly, increasing from 1.6 percent of total imports of SADC members in 1980 to 10.6 percent in 2003. Similarly, the share of intra-SADC exports as a portion of total exports grew from 0.9 percent to 10.6 percent over the same period.[9]

Trade patterns are quite asymmetric. South Africa is by far the largest supplier of exports to and demander of imports from the region. SACU accounts for between 71 and 78 percent of total intra-SADC exports. The region is even more dependent on South Africa as a source of imports. 90 percent of SADC (excluding SACU countries) imports from the region are sourced from SACU. Although a relatively high proportion of SADC economies' trade is conducted within the region, most of this is bilateral trade with South Africa. Reported trade flows between non-SACU SADC members are very low (less than 10 percent of total trade).

South Africa's prominence in intra-regional trade undoubtedly reflects in large part its entrepôt role—as a logistical hub for the region's trade with the rest of the world. This helps to explain why countries with the highest trade dependence with South Africa are those that are closely connected logistically to South Africa.

Intra-regional trade patterns suggest that the remainder of trade is based largely on exploitation of local and regional markets (and tariff preferences) for final goods. There is little evidence of development of regional production chains based on exploiting regional cost and productivity differences to improve competitiveness in global markets or against global competition.

A closer examination of the intra-SADC trade data reveals some concerns. Within SACU, of course, almost all trade is conducted under the rules of the customs union, not SADC. Outside of SACU, most trade also takes place outside of the SADC framework—under COMESA, under bilateral trade agreements or other special

[9] 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.

arrangements. Recent SADC Trade Audits on implementation of the SADC Trade Protocol (TSG/AECOM various years) have found that very little additional intra-regional trade had actually been created by the SADC agreement.

Failure to create more intra-SADC trade is attributed in part to delays and ambiguities in implementation of the Trade Protocol by various members and in part to administrative difficulties in complying with SADC rules, especially rules of origin. Although their goal is to promote preferential trade, multiple PTAs have added considerable complexity to and hence increased the costs of trade. The number of lines in South Africa's tariff schedule has been reduced from 11,231 to 6,697 between 1994 and 2004. However, the existence of just the EU and SADC agreements means that the effective number of tariff lines in force now is actually 20,081 (three times 6,697). This is almost twice the number of tariff lines in 1994.

Implementation of PTAs requires criteria and procedures for determining where goods actually originate—rules of origin. Rules of origin are complex and costly to comply with and to enforce. This is a serious impediment to trade, especially if they are deliberately designed to restrict preferential trade—to make it difficult if not impossible for importers and exporters to qualify. The EU rules under South Africa's TDCA are now widely recognized to be highly restrictive and to have a significant impact on the ability of South African exporters to take advantage of EU preferences. Similarly under the SADC rules of origin there is considerable doubt whether even South African exporters let alone those in much less developed partner countries could meet the criteria in many sectors.[10] This is a theme to which we return below.

4. ECONOMICS OF REGIONAL INTEGRATION

Regional integration can take many forms. Popular discussion often focuses on a "natural" progression from free trade areas to customs unions and eventually to common markets. However, the process of regional integration is truly multidimensional and there is no standard progression from one step to the next. Different groupings might have very different needs and circumstances. These differences, along with political and economic realities and constraints need to be taken into account. Before even beginning a discussion of tariff reform, it is worth drawing attention to a form of regional integration that is of particular importance in the SADC region – transit trade.

4.1 TRANSIT TRADE

Much of the traditional literature on regional integration ignores the role of transit trade. For landlocked countries such as many SADC Member States, transit trade is critical in maintaining access to world markets—both imports and exports. Even countries that are not naturally landlocked might benefit significantly from efficient access to entrepôt trade such as that provided by Singapore and Hong Kong in Asia. In SADC, South Africa is the obvious candidate to perform such a role and indeed already does so for much of the region's imports and exports. However costs are high, as result of a combination of hard and soft logistical infrastructure constraints. There are some possible alternatives to and/or useful competition for South Africa as

[10] See Flatters 2002a and 2002c and Erasmus, Flatters and Kirk 2006.

a key provider of logistical services and considerable effort has already gone into the creation of efficient transport corridors leading to both the Atlantic and Pacific oceans. But even these will depend at least to some extent on cooperation with South Africa and other Member States in both hard and soft infrastructure.

4.2 TARIFF REFORM

The first and most obvious focus of regional integration is on the preferential reduction of import tariffs among participating countries. Such tariff preferences have several types of economic impacts.

The main economic effect of preferential tariff reductions is to *encourage trade* among the participating countries. Trade created by elimination of artificial trade barriers is generally a good thing since it promotes specialization according to comparative advantage and encourages productivity growth through enhanced competition. Resulting productivity growth should also contribute to improved global competitiveness.

There are, however, significant differences between general tariff reductions that apply to all trading partners and preferential reductions that apply only to imports from selected sources. These can result in unintended adverse side effects that make preferential tariff reductions economically inferior to non-discriminatory reductions, and in some cases economically harmful. It is for this reason that regional trade integration, or preferential tariff liberalization, has the greatest economic benefits when it is part of a more general strategy to simultaneously liberalize and improve the openness and efficiency of trade with the world at large.

Unintended Effect: Trade Diversion (Imports)

The first unintended consequence of preferential tariff reductions is the possibility that they result in *costly trade diversion*—the artificial cost advantage given to suppliers in partner countries causes buyers to switch import demand from low cost third countries to higher cost PTA partner countries. While the tariff preferences make this profitable for importers, it raises the overall costs of trade to the importing country. The possibility and the cost of trade diversion depend largely on the difference between tariff rates imposed on the imports from rest of the world (MFN tariffs) and those made available to PTA partner countries. The greater is the difference between MFN and PTA tariffs, the greater is the incentive to substitute PTA partner imports for imports from elsewhere, and the greater can be the excess of partner's costs over those of third parties without making such a costly substitution privately unprofitable.

The obvious key to avoiding costly trade diversion is to ensure that preferential trade liberalization goes hand-in-hand with a program of MFN-based trade liberalization (or even better still to make all tariff cuts on a non-discriminatory basis). Just as with MFN trade reform strategies considered in isolation, the most important shorter-term target must be to eliminate MFN tariff peaks—to bring the highest MFN duty rates down towards the average, and at the same time, of course, to embark on a program to reduce the overall average. Not only will this eliminate the greatest trade distortions, but it will also reduce the most dangerous incentives for costly trade

diversion. *Preferential tariff reform and MFN-based tariff reform work best when used as complements, not substitutes.*

This approach was followed in a number of heavily protected sectors in Mauritius in conjunction with implementation of preferential tariff reductions in COMESA (see Box 7 of Flatters 2002c). Other countries, including South Africa, have been loath to do this.[11]

The MFN clause that lies at the heart of the General Agreement on Tariffs and Trade (GATT) and now the WTO (and that has largely been honoured in the breech in recent decades) has a foundation not only in concepts of equal treatment under the law, but also in basic economics—its application is a sure way to avoid costly trade diversion.

The same general lesson is true of other artificial policy constraints on trade, such as quotas, quantitative restrictions and import licensing schemes. Removing such constraints on an MFN basis is unambiguously welfare improving. But removing them on intra-regional trade while leaving in place barriers to third country trade risks causing costly trade diversion. The greatest gains arise from simultaneous removal of artificial trade barriers with all trading partners.

Unintended Effect: Trade Diversion (Exports)

Most discussion of trade diversion focuses on the costly diversion of imports. However, PTAs can have serious impacts on export decisions as well. Preferential access to a partner country with very high MFN tariffs in some sectors can induce investors and producers in partner countries to invest in these sectors purely to access the PTA partner's highly protected market, regardless of whether they have an inherent cost advantage in these products. While this might be a rational and profitable short and even medium-term response, it could give rise to longer-term costs from investing in "dead-end" sectors that are not globally or even regionally competitive and will not be sustainable when preferences are withdrawn or disappear as a consequence of more general trade liberalization by partner countries. Furthermore, businesses that depend on the shelter of high protection, whether in domestic or regional markets, face little incentive to innovate and improve productivity, the key to longer-term growth.

Unintended Effect: Administrative and Compliance Costs of Rules of Origin

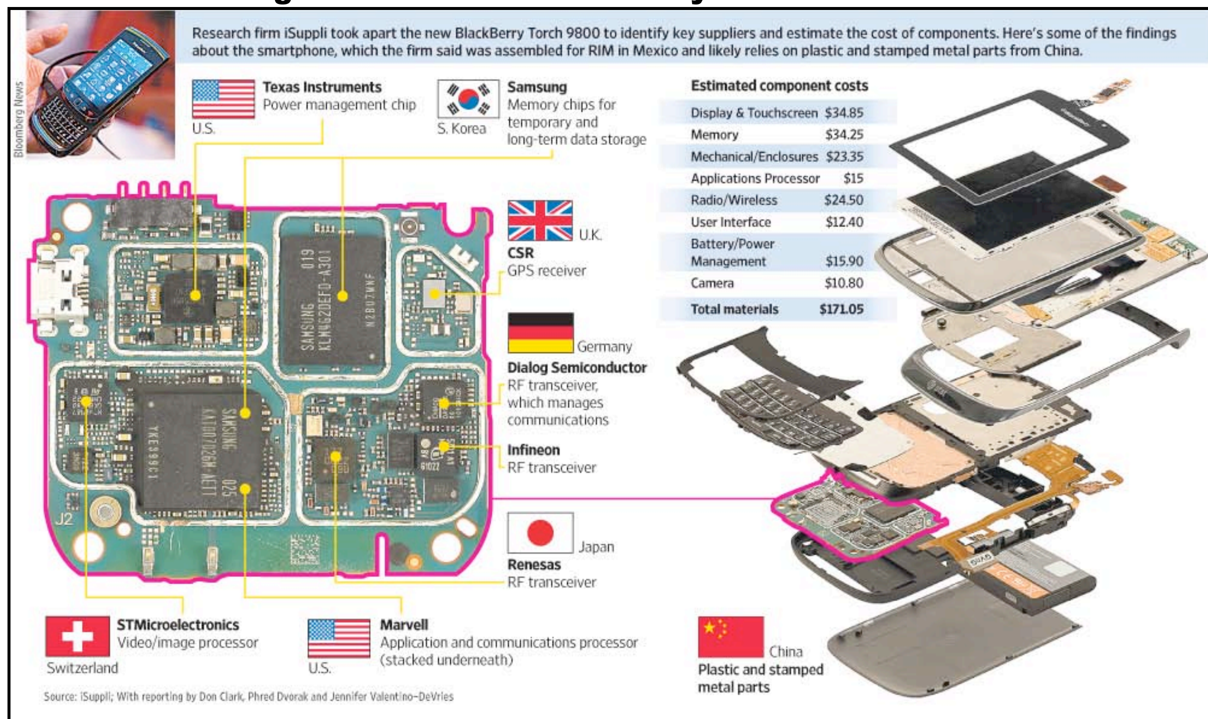
Another unintended consequence of preferential trade liberalization is the additional costs made necessary by legal and administrative needs of operating a PTA. Among the most important of these is the need for criteria and rules to determine whether goods can be considered to have originated in the region and accompanying procedures to certify whether goods claiming preferences actually meet these criteria. This is a far from trivial issue in today's world of highly integrated global

[11] One of South Africa's concerns about the EPA agreed by the EU and several of its SACU partners was a clause requiring the SACU partners to automatically grant the EU any tariff preferences provided in any future PTAs negotiated with non-EU partners. In fact, such an "MFN clause" would help to avoid trade diversion arising from future PTAs by forcing future PTA partners to compete on equal terms with exporters from the EU.

production chains, in which final goods are assembled in various locations and made up of components supplied from around the world, and designed in yet other locations.

The Blackberry Torch, for instance is a “Canadian” product, designed, produced and marketed by the Canadian company Research in Motion (RIM). However, as Figure 2 below shows, the phone is assembled in Mexico and its key components are made all over the world by a wide range of international companies, presumably using materials sourced in an equally diverse set of locations.[12]

Figure 2. Where a Blackberry Torch is “Made”



Source: Wall Street Journal, 16 August 2010

The international fragmentation of global production chains, whether for sophisticated smart phones or basic garments, is inherent in modern manufacturing processes. As a result there is no simple way to describe most manufactured goods as coming from any particular location.

A common sense approach to rules of origin would be to require simply that a good must undergo some “significant manufacturing activity” in a partner country in order to qualify for preferential import status in another partner country. In addition, certain trivial operations such as labeling and repackaging should be clearly designated as insufficient to confer origin.

In practice, however, “significant manufacturing activity” is a broad term and is subject to arbitrary interpretation. To provide greater commercial certainty, therefore, rules have to be made more precise. Precision is generally provided by expressing

[12] Although the application and communications processor, the “brain” of the phone, is shown as a product of Marvell in the US, it is most likely made in Taiwan. The investigators were not able to determine where the screen is manufactured.

the rules in terms of minimum amounts of partner country value-added, maximum amounts of third country content, or by defining certain necessary manufacturing processes. While such rules might sometimes increase certainty, there remains considerable room for administrative discretion. In addition, detailed rules and procedures almost always impose significant enforcement and compliance costs.

As a result, a considerable degree of arbitrariness is inherent in the design of any rules of origin regime. And the rules that are actually chosen are often costly to enforce and comply with.

Unintended Effect: Misuse of Rules of Origin

Of similar if not even greater concern is the temptation to try to design rules of origin to impose certain kinds of development patterns or simply to stifle preferential trade. This is done through the imposition of rules that act as local or regional content requirements. Using rules of origin as a “development tool” to encourage development of local upstream components industries, however, is generally costly and often has exactly the opposite of effect to what is intended (Erasmus, Flatters and Kirk 2006). International experience with just-in-time production methods shows that companies prefer to source locally and regionally and will go to considerable lengths to induce suppliers to make this possible. However, there are always limits to the amount of local sourcing that is cost-effective. To impose additional local sourcing requirements raises costs, reduces competitiveness of local producers and discourages investment.

Unintended Effect: Policy Diversion and Policy Subversion

Negotiating and implementing trade agreements is labour and time intensive. Devoting policy-making resources to negotiation of PTAs takes resources away from potentially much more useful MFN-based liberalization (unilateral or cooperative) and even more critical domestic constraints to growth. Of even greater concern is the danger that prolonged exposure to and involvement with trade negotiations encourages policy makers to see promotion of regional trade and negotiation of agreements as ends in themselves. This diverts attention from the real point of trade reform—to increase productivity and long-term economic growth.

Furthermore, by the very nature of most trade negotiations, the process often leads to a mercantilist attitude in which the ability to open up external markets is seen as a success, while “surrendering” of access to the domestic market is regarded as a failure. The goal of trade negotiations comes to be seen as opening third country markets and not at all about reforming and improving domestic trade policy. Trade negotiators see as their main “stakeholders” firms that view foreign competition as a threat rather than firms and investors whose competitiveness is weakened by artificial market barriers and restrictions, and who indeed might not even exist at the moment as a result of poor domestic policies. Trade negotiators need to be reminded that their work is part of a much more general strategy to promote longer-term growth of productivity and incomes.

Unintended Effect: Lower Government Revenue

Reducing tariff rates is likely to have a *negative impact on government revenues*. For countries in which customs duties are significant sources of revenue and especially those whose imports are heavily biased in favor of PTA partner countries, the impact on government revenue can be significant. Poorer countries generally are more dependent than richer countries on trade taxes as a revenue source. The main reason for this is their weak capacity to administer more sophisticated (and economically much more efficient) tax systems based on consumption or incomes.

At the same time, poorer countries often have the most to gain from trade reform in terms of its contribution to long-term economic development. In order to reap these gains, therefore, it is necessary for poorer countries to find ways to improve tax administration capabilities. Technical and even short-term budgetary assistance from richer and more developed trade agreement partners might be particularly useful in assisting with tax administration reforms—of significant economic value in their own right, quite apart from their necessity in adjusting to lower customs revenues resulting from trade reform.

4.3 CUSTOMS UNIONS: THE VALUE OF A COMMON EXTERNAL TARIFF

According to the plan set out in the RISDP, SADC was to become a Customs Union by 2010. A key distinguishing feature of a customs union as compared with a free trade area is the existence of a common external tariff. A common external tariff has the enormous benefit, at least in theory, of eliminating the need for internal customs controls on trade among partner countries for import duty purposes. This would also dispense with the need for rules of origin for trade among partner countries, since any goods circulating in the region must already have paid customs duties or have originated in the union. There is no scope or incentive for trade deflection, the problem that gives rise to the need for preferential rules of origin.

This being the case, why not move to a customs union immediately, thus avoiding the complications and costs of a PTA? Or at least why not move from a PTA to a customs union as quickly as possible?

- There needs to be agreement on the common tariff structure and on strategies and processes for changing it over time. If partners have significantly different MFN tariff structures, agreement might be very difficult to reach. Countries that have undertaken significant MFN-based tariff reform and/or who might have plans to do so in future might be forced to revert to higher and/or more varied rates than they wish. Once a common tariff structure is agreed, variations in the interests of different members might make it very difficult to undertake further MFN tariff reform. Rules that require that all partners' MFN tariffs move (or stay fixed) together make it impossible for members to experiment and lead the union by demonstrating the benefits of MFN trade reform. Incentives for trade diversion that arise from differences between (zero) intra-union tariff rates and higher MFN rates will be difficult to remove.
- There needs to be agreement on payment of the costs of tariff administration and on distribution of customs revenues among partner countries. A simple revenue allocation scheme would be to assign to each partner the revenues collected on

its own third country imports. This can be difficult, however, when one or more of the partners play a major entrepôt role, through which a large share of all union imports pass, regardless of their final destination in the union. Another problem arises from the possibility that some partners are not satisfied with the MFN tariff structure and think that some or all rates are too high. These partners might demand compensation for the cost-raising impact of such tariffs in the form of a larger share of the union's customs revenue collections. Calculating the amount of such compensation can be difficult; and it is often seriously over-estimated (Flatters and Stern 2005, 2006).

- Elimination of intra-union import tariffs and agreement on a common MFN tariff structure are not sufficient to ensure customs-free movement of goods in the union. Partners must trust in the ability and willingness of customs authorities in all partner countries to actually enforce the tariff. Suspicions of smuggling across one partner's external borders might lead other members to put in place alternative controls on their own borders to ensure that goods being traded within the union have actually paid all import duties owed on third country imports. Designing and implementing such controls can be difficult and the costs they impose on intra-union trade might exceed or at least seriously diminish the trade liberalizing benefits of the customs union. Successful implementation of a customs union requires trust in the efficiency and competence of all partner country customs services.
- For a customs union to operate efficiently there must be agreement not only on a common external tariff but also on the use of other restrictions and controls on third country imports. Without agreement on the use of antidumping measures used against third country imports, for instance, one country's antidumping tariffs could be avoided by importing into the union through another country. On the other hand, one country's wish to import a good without antidumping duties could be foiled by the decision of an entrepôt partner to impose such duties regardless of the ultimate destination of the goods in the union. As with smuggling, the kinds of border controls necessary to avoid these problems would go at least a long way towards defeating the purpose of the customs union. Lack of common policies on import licensing, import quotas and import bans would lead to the erection of similarly costly intra-union border controls.
- Some partners within the union might wish to put in place special trade measures to protect and promote the development of "infant" industries. If there is general agreement among all partners and if the policy involves simply a decision on the MFN tariff, then there is no special issue beyond reaching agreement on the MFN tariff structure. It is frequently the case, however, that only one or a small number of members feels the "need" for infant industry protection. Furthermore, the promoters of such protection might seek protection not only against third country exporters but also partners in the union. This would mean erecting tariff and maybe other barriers against imports from partner countries as well as the outside world. Once again, this would be a fundamental violation of the underlying principles of a customs union and would require complex and costly intra-union border controls.
- Membership in a customs union imposes major constraints on the ability of a partner country to engage in external trade negotiations. Changes in MFN tariffs, of course, must be agreed and implemented together with all one's union

partners. In fact, the same is true of any change in tariffs on imports from any third countries. This makes it very difficult, if not impossible to negotiate mutual tariff reductions with any country, any group of countries, or on an MFN basis. And membership in a customs union rules out the possibility of negotiating or joining another customs union except in the case that the new and old customs unions are merged into a single union.

4.4 "DEEPER" INTEGRATION

Policies on international trade and investment are critical elements in any economic growth and development strategy. Effective participation in global markets is essential for achieving acceptable rates of growth of incomes and more general economic welfare. However, this involves far more than bargaining with other countries about rates and timing of tariff reductions—the standard stuff of trade negotiations. It requires policies that promote competitiveness, and that reduce unnecessary costs of trade, investment and doing business. It is not just taxes, tariffs, import licensing and quotas that can restrict or encourage trade and investment. It is how these and associated measures are implemented; it is the costs and efficiency of international transport and of local and regional logistics; it is the availability and cost of financial and insurance services to support international trade and investment; and it is the way in which domestic regulations and markets work to encourage or discourage legitimate and productive business activities. See Box below on non-traditional ("deep") trade reforms in Indonesia.

Many of these policy areas are "sovereign"—countries are free to act as they wish; they are not bound by international agreements to act in any particular way. Even where international obligations exist, there is considerable scope for gains by moving beyond minimal requirements. However, there might still be significant gains from cooperation, and international and regional collaboration is evolving to take advantage of these opportunities. International customs cooperation through the World Customs Organization (WCO), for instance, is a prime example of the mutual gains to be realized by pursuit of common standards, rules and procedures. Customs cooperation and coordination is gaining recognition as a critical factor in improving SADC economic integration.

The WTO now includes guidelines and obligations regarding the use of product standards and other regulations to protect public health, safety and the environment. Implementing these and further follow-up measures are the focus of a variety of OECD regulatory initiatives, voluntary cooperation among APEC member countries, and are included in one way or another in a variety of bilateral and other preferential trading arrangements. The SADC Trade Protocol includes provisions on standards that echo those of the WTO and encourage the development of compatible standards among SADC members. As currently written, however, the Protocol provides little more than a framework under which to develop a SADC-wide regime for the treatment of technical standards (TSG 2003).

Whether done cooperatively or independently, there is growing recognition of the importance of finding measures to promote development through "deeper" economic integration, at the border and behind the border, through appropriate regulatory and policy reform. As we shall see below, the evidence on the need for this in southern

Africa is quite clear. This is a major focus of policy reform throughout the world. Regions and countries that fail to see the significance of this for future policy strategies are in danger of falling (further) behind.

Box: Non-Traditional Trade Policy Reform in Indonesia

In the early 1980s Indonesia launched a series of fiscal and trade policy reforms to reduce dependence on primary exports and increase the competitiveness of non-traditional manufacturing exports. This included improving non-trade and non-primary product based taxes and reducing and simplifying the structure of import tariffs. Before long it became apparent that there were a number of other critical barriers to export competitiveness. This resulted in the three most important trade policy reforms of the period.

- A labyrinth of import licensing requirements and quantitative import restrictions were strangling both imports and exports. As part of a laborious investigative effort the NTBs and their legislative bases were identified and, except for the few that served a legitimate economic or social purposes (or were simply too politically sensitive), were gradually eliminated.
- Inefficiency and corruption in Customs administration slowed and substantially increased the cost of importing and exporting. The President replaced the existing system of import control for all but the smallest import shipments by requiring that all inspections be done by a Swiss company in the country of export or at a convenient transshipment point. Customs officials were allowed to keep their jobs, but were forbidden to be involved in import inspections except in cases where there was clear evidence of tampering with seals on containers or other malfeasance.
- Inefficient ports and costly inter-island shipping regulations that protected domestic shippers from international competition increased the cost and time required for imports and especially exports. Port and inter-island shipping regulations were substantially reformed.

Discussions with major importers indicated that these reforms quickly reduced the costs of importing by as much as 20 to 30 percent. Over the next decade, driven by rapid growth of investment in and exports of manufactured goods, Indonesia's economy grew at more than 7 percent per year (despite two major oil shocks over the period), and the incidence of poverty fell from 40 percent in the late 1970s to 11 percent in the mid 1990s.

Source: Barichello and Flatters 1991 and Flatters 2005.

While there undoubtedly is potential value in continuing to reduce tariffs, whether unilaterally, multilaterally or preferentially, there is no question that the gains from these and other development policies will be enhanced by paying more attention to the investment, legal and regulatory changes that deepen economic integration among SADC economies and with the rest of the world.

This is an area of enormous breadth and scope, and one short paper cannot do justice to all of the issues. Rather than even attempt to do so, the remainder of this

paper will illustrate some of the most important issues by drawing on a few examples from or pertinent to the SADC experience.

5. THE SADC EXPERIENCE

5.1 THE BIG PICTURE: WHERE DOES SADC STAND?

For several years now the World Bank has been conducting annual surveys of the cost of doing business in 183 different countries, with a view to increasing awareness among policy makers of the scope for and benefits of regulatory reforms that will enhance competitiveness of and deepen integration among economies. These surveys have helped to focus the attention of policy makers around the world, and certainly in Africa, on the need for regulatory improvements to enhance their countries' competitiveness in world markets. The surveys are far from comprehensive and far from perfect as indicators of the cost of doing business in the countries that are covered. Of necessity, they focus on indicators that are relatively easily measured. They certainly do not provide a template for regulatory reform. Regardless of any resulting weaknesses, however, the surveys are generally regarded as useful indicators of the overall quality of the countries' business environments, and they provide a good starting point for in depth assessments of reform needs and possibilities in individual countries.

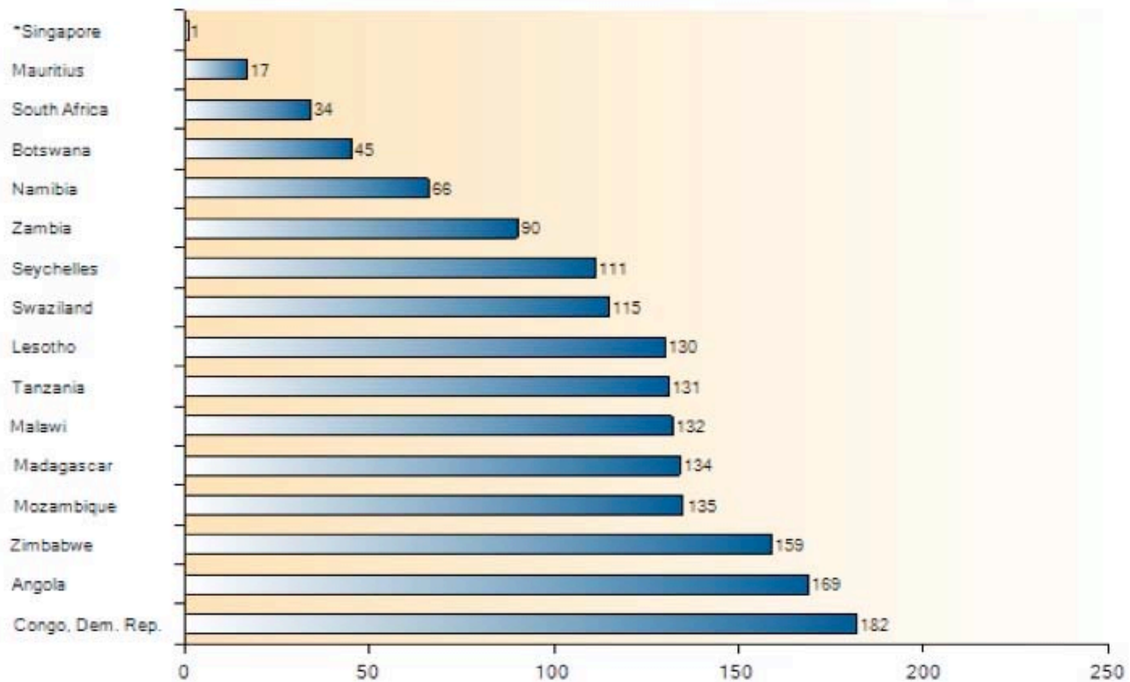
Figure 3 shows the overall rankings for SADC Member States according to the 2010 edition of the survey. For purposes of comparison, the SADC Members are benchmarked against Singapore, the country ranked first in terms of the quality of the overall business environment in the 2010. Rank number 183, by contrast, would indicate the worst regulatory environment among the 183 countries surveyed. The figure shows a huge variety in regulatory performance among SADC Member States. Mauritius stands out as a star, not only in the region, but also in the world, with an overall ranking of 17, placing it ahead of many countries at much higher levels of development. South Africa and Botswana, with rankings of 34 and 45 respectively also perform quite well for countries at their stages of development. On the other hand, over half of SADC Member States were among the 53 lowest ranked countries in the world.

The Bank's doing business rankings are derived by aggregating measurements for a variety of different indicators. Table 2 provides a summary of the indicators for the ten different categories used. The first column shows the overall rank of each SADC Member State, the same data as summarized in the previous figure. The remaining ten columns show the rankings of the SADC countries in each of the sub-categories. The SADC rankings differ considerably across the different indicators, and the patterns of "regulatory comparative advantage" also differ significantly across countries. Mauritius, the top-ranked SADC country overall, for instance appears to have considerable room for improvement in "getting credit." While Mozambique is ranked 135th in the world overall, it rises to 41st in "investor protection." South Africa, ranked 34th overall, is second in the world in "getting credit."

We can get some idea of pervasive patterns of particularly "good" or "bad" regulatory performance by asking, for each doing business category, how many SADC Member

States rank better or worse than their overall performance. For categories in which most Member States perform better than their overall ranking we might surmise that in some sense this is a category in which SADC overall has some relative strength (or less relative weakness), and vice versa if we find a category in which most Members perform worse than their overall ranking.

Figure 3: Overall "Doing Business" Rankings of SADC in 2010



Source: World Bank, Doing Business 2010: SADC, p.2.

The areas in which regulatory performance is relatively good (or at least relatively less bad) are "paying taxes," "getting credit" and "investor protection" in which 12 to 14 Members perform better than their overall average. On the other hand, the categories which stand out as showing particularly problematic regulatory performance are "registering property" and "cross-border trading" in which all but 4 and all but 5 members respectively rank lower than their overall averages.[13]

It clearly is difficult to generalize across SADC Member States. However, some clear conclusions emerge from the data in the previous table.

[13] Source: own calculations based on data in Table 2.

Table 2. World Bank Doing Business Rankings for SADC, 2010

	Overall Rank	Int'l Trading	Start a Business	Employing Workers	Register Property	Getting Credit	Investor Protection	Paying Taxes	Construct'n Permits	Enforcing Contracts	Close a Business
Angola	169	171	165	178	173	87	57	139	122	181	144
Botswana	45	150	83	71	44	43	41	18	123	79	27
Congo, D.R.	182	165	154	174	157	167	154	157	146	172	152
Lesotho	130	143	131	67	142	113	147	63	155	105	72
Madagascar	134	111	12	152	152	167	57	74	107	155	183
Malawi	132	172	128	92	101	87	73	24	163	142	130
Mauritius	17	19	10	36	66	87	12	12	42	66	73
Mozambique	135	136	96	156	151	127	41	98	159	129	136
Namibia	66	151	123	43	134	15	73	97	38	41	55
Seychelles	111	93	81	130	59	150	57	34	57	70	183
South Africa	34	148	67	102	90	2	10	23	52	85	76
Swaziland	115	158	158	55	158	43	180	54	24	130	68
Tanzania	131	108	120	131	145	87	93	120	178	31	113
Zambia	90	157	94	116	94	30	73	36	151	87	83
Zimbabwe	159	167	145	142	84	113	119	131	179	78	156

Source: World Bank, *Doing Business 2010: Reforming Through Difficult Times* and online database

- Without exception, SADC Member States have considerable scope for improving their regulatory environments to enhance competitiveness and growth. A few Members are doing better than countries elsewhere in the world at a similar level of development, but most are doing worse.
- There is enormous variety across Members in the level and sector detail of regulatory performance, suggesting there might be considerable room for cooperation in regulatory cooperation and reform.
- One area in which almost all Members suffer from especially weak performance (even relative to their low overall averages in many cases) is "cross-border trade." This is particularly disturbing when considered in light of more than a decade of activity in creating and implementing the SADC Protocol on Trade.[14]

5.2 REGULATORY IMPEDIMENTS TO LOGISTICAL EFFICIENCY

The global integration of world markets that has taken place in recent decades has facilitated and has been driven by a fragmentation of production around the world. Improvements in information technology, transport and logistics have made it possible to break down product value chains and allocate production tasks for goods and services much more finely and in line with comparative costs of production in different locations. Countries do not have to rely on the growth of domestic markets; they do not have to be self-sufficient in any set or subset of production; they do not need to be tempted down the self-destructive path of import-substitution as a means of developing local industrial competencies. This presents enormous opportunities for poorer countries as is well illustrated by the experience of many Asian countries.

In this environment logistics, ease of communication and trade facilitation are critical determinants of success in achieving economic development.

Transport infrastructure is clearly an important element in logistical efficiency. But it is only part of the story. An incentive structure and training environment in which crane operators can move 50 containers per hour achieves much more, at much lower cost, than one in which operators move 25 or 30 containers per hour.[15] Customs procedures and transit arrangements can add or subtract many days to or from the shipping times, a critical factor in a world of just-in-time production and constant customer-driven style changes. Transport regulations that protect local service providers from external competition by requiring the use of national carriers or imposing stiff fees on non-national carriers can add substantially to the costs of transit and other intra-regional trade.

The World Bank's surveys show that the cost of trading across borders is an area in which many SADC countries lag significantly. The indicators used for this purpose include complexity of customs procedures, container freight costs, and time to move traded goods between factories or warehouses and ports. SADC's geographic

[14] Even more stark and disturbing is the fact that the five members of SACU, the world's oldest customs union, and all members of SADC as well, have by far the greatest (negative) divergence between trade performance and overall regulatory performance.
[15] According to a Sri Lankan trainer working in South Africa two years ago, productivity differences between operators in Sri Lanka and at Durban in South Africa are of this order of magnitude.

isolation from major world markets and the landlocked nature of many of its Members are natural handicaps. The lack of sufficient scale of output and trade to attract regularly scheduled shipping, especially in smaller regional ports, results in a difficult "chicken and egg" problem in promoting industrial development. These handicaps increase the challenge, but also increase the potential gains from any kind of logistical improvements that can be achieved.

A recent study (Djankov et al 2006) illustrates the problem by examining the cost of time delays. Data were collected from freight forwarders, customs and port officials in 126 countries on the time it takes to send a container from a factory in the largest industrial city to the nearest port, and fulfill all the Customs and administrative and port requirements to load it on a ship. Table 3 shows that Africa is by far the poorest performer on average, and also has the greatest variation in shipping times.

Slow and variable shipping times impede export competitiveness both by reducing access to and increasing the cost of intermediate inputs, and by reducing the demand for and the value of exports. The study quantified some of these costs by estimating the (negative) impact of shipping times the volume of countries' exports. The impacts are significant.

According to these estimates "each additional day that a product is delayed prior to being shipped reduces trade by more than 1 percent. Put another way, each additional day is equivalent to a country distancing itself from its trading partners by one percent, or about 85 km. For example, if Uganda reduced its factory-to-ship time from 58 days to 27 (the median for the sample), exports would be expected to increase 31 percent and Uganda would bring itself 2,600 km closer to its main trading partners—nearly the distance from Kampala to Cairo. If the Central African Republic reduced its factory-to-ship time from 116 days to 27, exports would nearly double. The same effect could be achieved if the Central African Republic cut 7,565 km from its distance to the main markets—three-quarters the distance from Bangui to New York." (Djanov et al 2006, pp. 4-5)

Table 3. Required Time for Exports (Number of days)

	Average	**Minimum**	**Maximum**
Africa	48	16	116
Developed Countries	13	5	29
E Asia & Pacific	24	6	66
Europe & Central Asia	32	6	93
Latin America & Caribbean	29	17	43
Middle E & N Africa	28	10	49
South Asia	33	24	44
All Countries	30	5	116

Note: Shipping time is the number of days necessary to move a container from factory to port and fulfill all necessary customs, administrative and port procedures to prepare for loading on board ship. *Source:* Djankov et all 2006, Table 1.

What does this mean for policy? It suggests there are potentially large economic gains from increasing logistical efficiency and reducing unnecessary shipping delays.

Within each country we need to streamline customs and port procedures through improved risk assessment methods, reduced reliance on physical inspections of cargoes, greater use of electronic data filing, etc. Among bordering countries we need to find ways to harmonize customs documents, share standard customs forms and data, and harmonize transit procedures, including those for customs bonds where these are necessary. Within and between countries there is an urgent need for removal of regulatory and market structure barriers to competition, such as cabotage restrictions and a wide range of policies designed to keep out and/or restrict the operations of foreign transport operators.

SACU and SADC have expended considerable effort in this regard. SACU now has a common customs document for intra-SACU trade. The same document is now being used in the Dar es Salaam Corridor countries of Malawi, Tanzania and Zambia. Considerable work has been done to streamline several key regional transport corridors, to improve transit procedures and to simplify bonding requirements. But progress, although significant, is slow. As in all regulatory reform, bureaucratic resistance is strong, and vested interests exert pressure to preserve particular ways of doing things.

The current and seemingly endless Doha Round of multilateral trade negotiations has consumed enormous energy by trade negotiators in all member countries. On the SADC side a major focus of most countries has been to seek reductions in tariff barriers to exports to the rich markets of the US and the EU. If successful, this would certainly be useful. With a few exceptions, there has been great reluctance to make "concessions" in the form reduced MFN tariff rates for imports into SADC markets. How would the results of all these efforts compare with the effects of improving domestic and intra-regional own logistics in SADC? According to this study, "In Sub-Saharan Africa it takes 48 days on average to get a container from the factory gate loaded on to a ship. Reducing export times by 10 days is likely to have a bigger impact on exports (expanding them by about 10 percent) than any feasible liberalization in Europe or North America" (Djankov et al 2006 pp. 21-22).

5.3 RULES OF ORIGIN AS CONSTRAINTS TO SADC INTEGRATION

Regional economic integration can be a useful avenue to achieving more general integration into the global economy. However, if regional arrangements are undertaken with a view of insulating the participants from broader global forces, they could divert policy attention from the more important task of increasing global competitiveness and, even worse, reduce growth and efficiency by diverting trade from low cost to high cost sources.

One of the weakest links in PTAs as a path to economic integration is the necessity of introducing rules of origin—criteria for ensuring that goods claiming trade preferences actually originate from a country eligible for such preferences. In today's world of fragmented production, with production of the elements going into any final good taking place in many different places around the world, determining origin can be a tricky business. In fact, the whole idea of thinking of a good as originating in any particular place is foolish. An iPod, for instance, is assembled in China. However, less than 10 percent of its total final value actually originates there; the rest can be attributed to manufacturing and other activities that take place in many different

locations all around the globe. See the earlier reference to Blackberry smart phones.

For the purposes of administering a PTA, the real question is not whether a product claiming preferential treatment actually *originated* in a member of the PTA, but rather whether significant economic activity involved in its production occurred there. Was the supplying country in some meaningful sense a part of the global value chain for the production of the good claiming preferences?

Rules of origin regimes usually deal with this question in two ways. The first is to declare certain trivial activities such as packaging, labeling, and simple mixing of chemicals as insufficient to confer origin. The second, as a means of providing additional clarity, is to specify some minimal types of economic activity as being necessary to confer origin. This could be indicated by levels of local content, substantial transformation of products (often as determined by a change of tariff heading when moving from inputs to outputs), or specification of particular production activities that need to have taken place (such as cutting and stitching of cloth to make a garment).

Unfortunately, as happens in many trade-negotiating processes, something was lost when SADC progressed from these simple principles to actual implementation.

In preferential arrangements with and among developed countries, special interests in the richer countries often see rules of origin as a way to diminish the value of preferences granted or to provide hidden protection for their own products. The classic example is the garment industry, where both the EU and the US textile and garment producers lobbied to insist that if preferences were to be granted to garments produced in poorer countries, they must be made from cloth and/or yarn produced in the preference-granting country or region. The only alternative was to use cloth and/or yarn produced in the preference-using country. Both of these criteria, of course, are an attempt to deny the whole process of global division of labor that characterizes the globalization of production over recent decades. In so doing these rules diminish and might even negate the value of the preferences being granted.

In the case of AGOA an exception was made for a number of the least developed beneficiary countries to allow their garment makers to source fabric from third countries—i.e. with some restrictions and with a certain time limit (extended several times now, but not without creating troublesome uncertainty for producers) they were subject to a much less restrictive single transformation rule for garments. This turned out to be a great boon to a number of SADC countries, especially Lesotho and Swaziland. Because of this less restrictive rule of origin, AGOA preferences resulted in substantial exports and the creation of thousands of jobs.

The importance of the single transformation rule of origin was illustrated by a bill passed by the US Congress requiring that garment makers in these countries source specific fabrics locally, but only if they were "commercially available" in the region. The first fabric chosen for this requirement was denim, for which there were several factories operating in Lesotho and South Africa. The requirement turned out to be far less innocuousness than had appeared. Although considerable amounts of denim were being produced in the region and were being used in jeans and other garments

exported under AGOA, the quantities and qualities available were not always sufficient to meet the garment-makers' demands, and the uncertainty created by the new requirement threatened to cause the closure of factories making both clothing and denim. Of course the garment makers preferred to source locally; but to require them to do so under conditions set by a US government agency increased the costs and risks of their businesses. The rule provided no more assistance to the local fabric makers than was already available as a result of the interests of the garment makers themselves. In other words, the requirement was either redundant, in which case it was unnecessary; or it increased costs for the garment makers and hence threatened the viability of their businesses.[16] Fortunately the Congress realized the dangers created by the denim requirement and repealed it before it caused serious harm.

Rules of origin in PTAs among developed countries are often complex and, at least for "sensitive sectors" such as textiles and clothing, quite restrictive. This reflects the lobbying of vocal interests in these sectors who wish to use rules of origin to protect them from competition arising from the granting of preferential tariff reductions. This is the approach that was followed, by and large, in South Africa's TDCA with the EU. The textile and garment industries in particular were saddled with the restrictive double transformation requirement.

This approach to rules of origin was challenged in both rich and poorer countries during the EPA negotiations with the EU. The challenge met with considerable success and the resulted in much less restrictive rules of origin for a number of sectors of importance to developing countries. In particular, in a triumph for economic rationality and for the interests of workers in poorer countries, the single stage transformation rule was agreed for textiles and clothing. This, however, left South Africa in the anomalous situation of still facing a more restrictive rule in its own agreement with the EU and it became one of the principal points of contention within the so-called SADC negotiating group. South Africa's complaint appears to have been not that it wished to have access to the less restrictive rule, but rather that it feared competition from "cheap" European garments entering the South African market through SACU or SADC partner countries that benefited from the more lenient rule of origin.

In south-south PTAs, complex and restrictive rules of origin have come to be justified as development tools—a way to stimulate the development of upstream-downstream production networks by making local or regional content a necessary condition for enjoying trade preferences (see Erasmus, Flatters and Kirk 2006). It is well known from more general trade and development experience that this is a heavily flawed development model, and this is why local content and other performance requirements are outlawed in most MFN-based trade arrangements, and most importantly in the WTO.

Nevertheless, this approach heavily flavored the difficult SADC Trade Protocol negotiations. As has been recounted elsewhere, the starting point for the SADC rules of origin was a set of relatively flexible and simple rules, with little or no attempt to fine tune differences across sectors. Largely as a result of South Africa's

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[16] See Flatters 2007.

insistence the rules that were agreed were far more complex and had many resemblances to those in the EU-South Africa TDCA (Flatters 2002a; Erasmus, Flatters and Kirk 2006).

In many cases, the real motivation behind the use of such restrictive rules of origin, as is the case in developed countries, has been to provide hidden protection to reduce the impact of trade preferences on firms and industries that fear external competition.

A justification that is often given for such protectionist use of rules of origin is to compensate for lax customs and/or standards enforcement in partner countries. In order to prevent use of the PTA for "smuggling" of non-eligible, dumped or sub-standard goods from third countries, rules of origin are made so restrictive that no company in the exporting country could possibly satisfy them. In other words, rules of origin can be and are used to exclude certain goods from trade preferences.[17]

To the extent that these kinds of arguments are legitimate and are not simply back door ways to increase protection, the solution is not to prevent legitimate preferential trade from taking place, but rather to cooperate to improve customs enforcement among member countries. As we have already observed, poor customs administration can be a serious and costly impediment to development of international competitiveness. Cooperation in improvement of customs services is a worthy goal in its own right.

There remain a number of unresolved issues over SADC rules of origin.

- There is a general feeling among many Member States and external observers that the rules are excessively complex and in at least some key sectors highly restrictive.
- There is a fundamental disagreement between South Africa and several of the smaller, poorer Member States about the double transformation rule for textiles and clothing. South Africa insists on the double transformation rule to protect its own garment industry and (less convincingly argued) to support the local and regional textile industries. The fundamental problem is South Africa's tariff structure in this sector, with tariff rates of 40 percent and more for many garments and around 20 percent for many domestically produced fabrics. As long as South African garment makers suffer the cost-raising impact of the fabric tariff it would be difficult if not impossible to compete in the domestic market against tariff free SADC garments made in partner countries that do not protect their domestic textile industries (or at least not to the same extent as South Africa). As long as South Africa maintains this tariff structure there will be no agreement on economically sensible rules of origin for this sector. Rather than tying the rest of SADC to an indefensible rule of origin, would it not be preferable for South Africa to exclude this sector from SADC free trade, and allow other Member States to trade according to a rule that would actually allow trade to take place?
- There is still no agreed rule of origin for wheat flour. Initial disagreements appeared to be based on differences in the interests of wheat-growing and non

[17] See Flatters 2002b for the case of textiles and clothing in SADC.

wheat-growing Member States. South Africa in particular argued that its wheat import tariff aimed at protecting its own farmers would be circumvented if flour millers in other Member States could make flour from duty-free wheat and export it to South Africa under SADC tariff preferences. It was argued that a rule of origin requiring that flour be milled from regionally grown wheat was the only way to avoid this threat. Such a rule would be impossible to meet in non-wheat-growing states, especially since South Africa itself was a net importer of wheat. Subsequent removal of the South African wheat duty and recognition that South African wheat farmers were often receiving only an export parity price for their wheat cast doubt on the validity of South Africa's justification for their proposed rule of origin. It pointed attention instead to monopolistic practices in several SACU flour markets and to the lobbying of regional millers for a rule of origin that would protect them from regional competition. Findings of South Africa's Competition Commission provided support to this view. South Africa eventually agreed to a much more sensible change of tariff heading rule, but progress is now blocked by insistence on the wholly produced rule by several other wheat-growing Member States. As long as negotiators remain captives of monopolistic local producers or faulty economic logic, the prospect of agreement on a SADC rule of origin in this sector remain slim.

Regardless of their restrictiveness or complexity, rules of origin add to the costs of preferential trade. These costs almost certainly increase with the complexity of the rules, of course. A recent study found that it costs one SADC retailer about R40 million per year, or almost one-half of the value of its duty savings from SADC tariff preferences, simply to comply with rules of origin (Charalambides 2010, p.21). This refers only to the compliance costs of rules of origin and not to the administrative costs of customs in implementing them (or to the potentially much greater economic costs arising from the distorting effects of the rules on investment and other business decisions).

5.4 TRANSIT ISSUES AND CUSTOMS COOPERATION

Lack of trust and/or differences in trade policy goals can result in other troublesome customs enforcement difficulties in our own preferential trading arrangements, with harmful consequences for international competitiveness.

Consider a garment industry in a small, poor landlocked country that is utilizing developed country trade preferences to compete in global markets. Firms in this industry depend critically on timely and efficient transshipment of most major inputs and of all outputs through internationally linked ports in neighboring countries. Suppose the country of transshipment were to insist on physical inspection of sealed containers, often including unstuffing and restuffing of the contents, when goods pass through in transit. This would be a serious impediment to the import and export trade of the affected companies, certainly would reduce their net factory prices and might well threaten their whole business. International buyers generally have a very low tolerance for such shipping uncertainties and associated costs.

Unfortunately this is not a hypothetical example. It actually happens in the SADC region, and even in SACU, a customs union in which there should be free movement of all goods (Mpata et al 2005a and 2005b, Flatters and Elago).

The garment transshipment example arises in part because of lack of trust among the relevant customs authorities and in part because of differences in trade policy. In this case, South Africa chose to restrict imports of a number of textile and garment products from China in order to protect its own industries. Under pressure from these industries, customs authorities became excessively vigilant about all textile and garment shipments, to the serious detriment of the competitiveness of legitimate regional firms competing exclusively in global, not regional markets.

Similar issues have arisen with respect to deposit requirements for indirect taxes on transshipments of exports to the US and EU from companies in small SACU Member States.

Rules and procedures for secure and speedy transit should be negotiable even in the absence of a free trade agreement, let alone a customs union. Comprising a number of landlocked countries that rely on access to ports in South Africa and other Member States, this is an issue of urgent importance in SADC. Useful work has already been done in this area. Much more needs to be done.

5.5 TARIFF PREFERENCES, PROTECTION AND COMPETITIVENESS

Trade diversion that might arise from a PTA is generally looked at from the perspective of the importing country. The flip side of the same phenomenon, viewed from the perspective of the exporter, might be referred to as “export diversion” resulting from access to preferential tariff treatment in the protected market. Being granted access on a duty-free basis to a protected market in a partner country is analogous to an improvement in an exporting country’s terms of trade. To the extent that the benefits are passed through to domestic producers, taking advantage of such opportunities is welfare improving, at least as long as the preferences continue. Whether this is advantageous in the longer run depends on whether the preferences remain in place, a doubtful assumption in most cases, and/or whether exporters are able to take advantage of temporary preferences to improve productivity and increase competitiveness. If preference margins are large, the long run risks might be significant.

Consider a hypothetical garment producer in a small SADC country that has no textile industry and which levies no import duties on fabric, at least for garment exporters. What “protection” is offered to such a company when exporting to markets with different preferential regimes? For expository purposes we assume that fabric is the principal intermediate input and that the amount of fabric necessary to produce garments worth $100 in the world market costs $70 at world prices.

To export in global markets with no special preferences the company must be able to produce at the same cost as other globally competitive producers. It must sell at $100 and purchase fabric at $70. Its processing costs cannot exceed $30, the same as other globally competitive producers. Effective protection when selling without preferences is zero.

Suppose first that the country qualifies for preferential access to the US market under AGOA (with a single stage transformation rule of origin, allowing it to purchase fabric at world prices, in world markets). The typical US tariff on imported garments

is about 17 percent. The SADC exporter can now charge up to $117 and still compete against producers that do not have access to AGOA preferences. That means its manufacturing costs can be as high as $47 ($117 – $70, the cost of fabric); it could compete even if its costs were as much as 57 percent higher than those of globally competitive firms. In other words, the AGOA preferences give the exporter “effective protection” or a subsidy of 57 percent of globally competitive manufacturing costs.[18]

Now consider the effect of gaining preferential access to the SADC market (with a single stage transformation rule of origin, allowing it to purchase fabric at world prices, in world markets). In effect this gives the partner country garment producer access to the heavily protected South African where the import duty on third country imports is 40 percent or more. At a tariff rate of 40 percent, the partner country exporter can sell at up to $140 and still compete against third country imports. With a fabric cost of $70, manufacturing costs can be as high as $70 (the sales price of the garment less the fabric cost of $70), which exceeds globally competitive manufacturing costs of $30 by a margin of 133 percent. Preferential access to the South African market is equivalent of a subsidy (or effective protection) of 133 percent of globally competitive manufacturing costs.

Compare this with the subsidy the same tariff structure gives to the South African garment producer selling in the domestic market. The garment tariff also allows the South African producer to sell for as much as $140 and still compete with global producers. But South Africa also protects its textile industry. At a tariff rate of 20 percent the South African producer’s fabric costs are increased from $70 to $84. Therefore its manufacturing costs (excess of selling price over fabric costs) can be as high as $56 ($140 - $84) and still compete against third country imports. This is still substantially higher than globally competitive costs of $30—in fact 87 percent higher. The South African tariff structure gives its own garment producers a subsidy (or effective protection) of 87 percent of globally competitive manufacturing costs when they sell in their own market.

Table 4. Effects of AGOA and SADC Preferences for Garment Producers

Producer		**Partner Country Exporter**		**SA Producer**
Market	**World Prices**	**US (AGOA)**	**SA (SADC)**	**SA**
Max. Mfg. Cost	30	47	70	56
Rate of Subsidy (%)	0	57	133	87

Source: Own calculations based on world garment price of 100 and world fabric cost of 70.

Table 4 summarizes the effects of AGOA and SADC preferences for a partner country producer exporting in several different markets, and also for a South African producer selling in South Africa. Assuming availability of a single stage transformation rule of origin, the ability to be exempted from the apparently rather modest 17 percent US duty rate on garments is equivalent to being granted a 57 percent subsidy relative to globally efficient net manufacturing costs. Duty-free access to the South African market under SADC on the same terms provides a much larger subsidy of 133 percent relative to third country exporters to South Africa.

[18] This is derived as the percentage excess of 47 (maximum local manufacturing costs) over 30 (globally efficient manufacturing costs). For more explanation see Flatters 2004.

Furthermore although the South African tariff provides a substantial subsidy to its own producers (87 percent), a partner country's freedom from the South African import duty on textiles allows the its producers' costs to be even 25 percent higher than a South African producer's (70 compared with 56) and still be able to compete against South African producers in that market.

Tariff preferences can give substantial subsidies to producers in beneficiary countries and so it is not surprising that investors respond to them. As long as the preferences continue this can be of substantial benefit to the recipient countries. However, it is dangerous to assume the preferences will continue indefinitely. As is well-known preference margins can be eroded by general tariff reform and/or as a result of extending them to growing lists of countries. As is particularly obvious in the case of garments, their value also depends on ancillary conditions, especially rules of origin that determine whether important inputs can be sourced at competitive cost in world markets. None of these factors is under the control of beneficiary countries.

If investors are so uncompetitive that they need levels of subsidy like those shown above, it might be legitimate to ask whether they can hope to be sustainable when preferences diminish. There is at least some possibility that the incentives created by such preferences attract investors that are in the business simply to reap the benefits of the subsidies and will disappear when the preferences are eventually eroded. While there might be some gains in terms of worker training and other external benefits, it is not clear that this is the best long-term development strategy.[19]

If the preferences are necessary to kick-start industries that are impeded by regulatory and other policy-based constraints, they might provide a window for developing and implementing a long-term strategy for dealing with such underlying competitiveness issues. But with or without preferences and other subsidies, it is these regulatory constraints that should be the real goal of development policy. Meanwhile, there is a real danger that preference schemes will distort investment decisions into areas that do not represent the best long-term prospects for the country.

5.6 INFANT INDUSTRIES

A number of countries have expressed misgivings about participating in a preferential trading arrangement because of a fear that it will restrict their ability to protect "infant industries."

The infant industry argument has a long history. Infant industry protection is usually based on the argument that firms need temporary protection to cover losses in early years until they become competitive and profitable later on. However, this in itself is not justification for protection. Almost all businesses and investments involve start up costs that will only be covered by later surpluses. If the net present value (NPV) of the long-term cash flow is not positive, the business is not viable. This does not in itself provide a public policy justification for support.

[19] Namibia's efforts to lure a large textile and garment producer to locate in a suburb of Windhoek to take advantage of AGOA did not take account of all the public and external costs of doing so and turned out to be of very questionable long-term benefit for the country. See Flatters and Elago (2008).

There are two exceptions to this.

- The NPV might be positive but capital markets are incomplete or imperfect and financing cannot be obtained. If this were the case we could make a public policy argument for commercially based financing. But a) imperfections in capital markets are generally not industry specific. To favor some industries with "infant industry" support distorts resource allocation in favor of those supported and against those that are not supported. b) Import protection is clearly inferior to fixing the capital market problem. It unnecessarily distorts consumption decisions (price-raising impact of the tariff) and it favors import substitution activities versus export oriented ones. c) Is the government better qualified than financial market experts in assessing the viability of investments and their ability to repay loans and/or provide a reasonable return to investors? Don't confuse "banks are unwilling to lend because risks of failure are too high" with "capital markets are imperfect."
- There might be some external benefits arising from the investments that are not captured by the investors. In this case the solution is to identify the external benefits and deal with the eternality at source through appropriate regulatory or financial incentives. A protective tariff is a poor second or third best due to its consumption and import substitution distortions. And once again there is the problem of the government's ability to distinguish genuine external benefits from self-serving claims by investors. The mirror image of the same problem might arise from private costs that exceed social costs due to distortions in some input market. These would also discourage socially valuable investments. The most obvious case is a market wage that exceeds the opportunity cost of labor (due to unions, minimum wages and other labor market distortions). Once again the answer is to deal with the distortion rather than giving selective import protection or other *ad hoc* support. Business Process Outsourcing (BPO) is another case—high telecommunications costs artificially inflate costs and discourage investment. Once again the answer is to improve competition and fix regulations in the telecommunications sector. These high costs affect many other industries in the economy, not just BPO.

The case for selective support of “infant industries” is generally quite weak. Claims for such support more often than not represent simple special interest lobbying. In any case, restrictions on imports are very poor tools for providing such support, especially in typical SADC countries in which markets are very small and thus inadequate to provide the basis for a globally competitive industry in the short or long run.

Nevertheless, in response to concerns of its smaller Member States, SACU included in its latest agreement specific provision for countries to provide infant industries protection against import competition for up to eight years.[20] This clause has been used on a number of occasions—pasta in Namibia and bread and Ultra High Temperature (UHT) milk in Botswana, for instance. Examining these cases is instructive.

Namibia chose to take advantage of the SACU infant industry provision in the pasta

[20] The SADC Trade Protocol has a similar infant industry clause, but with no specific time limit for its use.

sector prior to the implementation of the SADC Trade Protocol.[21]

The SACU MFN tariff on pasta is 25 percent. At the request of the local flour-milling group that wished to build a new pasta factory, the government agreed to impose an additional import duty of 40 percent, to remain in place for four years and then be phased out gradually over another four years. Since the milling branch of the company gets wheat on a duty-free basis, its flour is also effectively duty-free, except for any excess of its milling costs over those of international mills.

The factory was completed in 2002 and was soon operating at almost 100 percent of capacity—three shifts, seven days a week. It was obviously a commercial success. This should not be surprising in light of the very high levels of protection provided by the infant industry tariff. The effective rate of protection *vis à vis* South African producers is about 89 percent while *vis à vis* international competitors it is about 425 percent (based on cost data from the firm).

Other than rents created for the (South African owned) firm, what benefits did the infant industry protection give to Namibia?

Small increases in demand for local wheat did not affect the price received by farmers. They receive no more than the pre-tariff world market import parity price regardless of local demand.

What does the new pasta factory provide for consumers? Increased import duties ensured that consumers had much less choice in buying pasta. The factory employs a special high temperature process that allows the use flour milled from local wheat rather than higher quality durum wheat. This gives a product that is acceptable to some consumers, but disagreeable to many others. A tour of local supermarket shelves revealed only the local brand. 'Specialty' pasta ('normal' pasta in most other markets) had to be bought at high duty-inclusive prices in specialty shops. High prices and low sales volumes have made this an unprofitable product for most supermarkets to stock.

What about employment? The pasta factory operating at full capacity with three shifts employed a total of 20 workers (10 less than the minimum promised when applying for infant industry protection). But this is an overestimate of the net job creation from the factory. Prior to its establishment, another local pasta producer served the local market with pasta made from flour purchased from the milling company that operates the new pasta plant. Shortly after the new pasta plant opened, the old producer's line of credit with this miller was revoked and it had to close its factory. Data have not been obtained on the number of job losses this caused. But it can be stated with certainty that the net number of jobs created by this infant industry protection is less than 20.

In 2007 Botswana utilized the SACU infant industry clause by imposing a 40 percent tariff on imports of UHT milk from all sources, including its SACU neighbors. This measure was put in place to support a single new UHT milk factory that apparently employs 60 to 100 workers. Most of the raw dairy products needed in the production

[21] This summary of the pasta case draws on Erasmus and Flatters 2003.

process are imported, and the SACU tariff is zero. Assuming that the raw milk products make up 70 percent of costs, the effective protection provided by the 40 percent duty on UHT milk can be estimated as 133 percent—a very generous rate of subsidy indeed. Based on available estimates of UHT milk consumption (both imported and domestically produced) the cost of the tariff to consumers in terms of higher UHT milk prices is about USD16 million per year.[22] With 100 workers in the factory this amounts to a cost of USD 160,000 per job per year, and if the number of workers is 60, the annual cost is USD 266,667 per job. The annual wage of such factory workers is not likely to be more than USD 1,500, only a very small fraction of the cost of supporting these jobs through infant industry protection.[23]

At least in these cases, it seems that the use of infant industry protection has not been based on developing globally competitive firms and industries or creating significant numbers of sustainable manufacturing jobs. Protected firms are focused only on tiny, heavily protected local markets. Whatever jobs have been created (and the number is certainly small) it has been at very high cost, with little prospect of leading to the development of competitive industrial sectors. The main beneficiaries have been special interests that have succeeded in lobbying for policies that create large short term profits and very little else. Infant industry protection in practice has been very different than what would be recommended on the basis of sound long-term development policy.

6. CONCLUSION: WHAT HAS BEEN LEARNED? WHAT NEXT?

Trade policy is one of many tools that can be used to improve productivity, increase competitiveness and promote long-term economic development. Viewed in this broader context trade policy is about far more than tariff negotiations; and SADC is about far more than simply implementing and extending the Trade Protocol.

6.1 WHY IS SADC INTEGRATION IMPORTANT?

SADC is small; for most internationally traded goods regional markets are too small and geographically fragmented to provide a base for firms to establish globally competitive operations. To focus primarily on products in which firms can compete locally and regionally, but only under significant protection against third country imports is of limited value at best and is likely even to point investors in the wrong direction. The focus must be on creating an environment in which investors can think about competing internationally. When this begins to happen, SADC growth will accelerate and the SADC market will eventually merit real attention. But growth based on larger global markets must come first, as happened in East and Southeast Asia.

Regional integration works best if it is based on improving global competitiveness of

[22] Resulting tariff revenues are placed in the SACU Customs Revenue Pool and hence are almost entirely distributed to the Treasuries of other SACU governments.
[23] The calculations and estimates in this paragraph are the author's and are based on data from the most recent WTO SACU Trade Policy Review, from official Botswana trade statistics and from interviews and discussions with experts and researchers in Botswana.

regional products. It relies on reducing all impediments to trade within the region, while at the same time using this as platform for the similar removal of impediments to trade and investment with the entire world.

ASEAN, which started its regional integration with much larger markets than are found in SADC, built a free trade area and improved regional integration on the basis 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 parcelled 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. This has not yet begun to happen in SADC.

6.2 HOW IMPORTANT IS A SADC CUSTOMS UNION? WHEN?

The RISDP called for formation of a SADC customs union by 2010. It is now accepted that this deadline will not be met. An obvious advantage of creating a SADC customs union, at least in principle, is that it would improve regional integration by reducing the need for intra-regional border controls, especially those related to enforcing rules of origin. Against this, however, must be weighed several considerations.

- Rules of origin are only one of many barriers to regional integration in SADC. Dealing with these other barriers is of great economic importance to the future development of the region and they can be dealt with independently of a customs union. The important policy question for SADC and its Member States is whether negotiating a customs union would assist in dealing with these issues or whether it would serve instead as an unnecessary distraction. In developing a policy strategy it is important to consider carefully both where the greatest economic gains are to be made and what is most likely to be politically and administratively feasible.
- Based on experience to date, it would appear that a number of countries are simply not ready for a customs union, or even for complete intra-SADC free trade. A customs union in which members insist on the right to impose tariffs, quotas, bans and other restrictions on intra-regional trade in order to pursue economic development goals would be a futile exercise, as would a union in which poorer countries are too dependent on customs revenue to contemplate reducing import duty rates on trade with important partner countries. On the fiscal side, technical and maybe even temporary budgetary assistance might be necessary to help poorer countries reduce dependence on this relatively inefficient revenue source and prepare them for entry into a customs union.[24]
- There are even more basic issues such as rules and guarantees on transit trade that can and should be dealt with long before a customs union or even completion of the SADC FTA.

[24] The possible revenue problems arising from implementation of the SADC Trade Protocol were recognized at early stages of the negotiations. They remain a problem for some of the smaller and poorer Member States. See Flatters et al 2001.

- Formation of a customs union requires agreement on overall tariff policy—not only on a common external tariff structure but also on a strategy for future preferential and MFN-based tariff negotiations as well as for contingent protection such as antidumping and safeguard measures. These are questions on which there are huge differences among SADC Member States. Mauritius plans to eliminate all MFN import duties and become a duty-free island. South Africa, on the other hand, sees import tariffs as a key tool in its overall industrial policy. These two examples simply illustrate the range of different approaches to tariff policy among SADC Member States. To force agreement on a common tariff would require either undoing substantial reforms that have already taken place in some countries, or forcing other countries to move more swiftly on MFN tariff reform than they are currently prepared to do.
- Differences in approach to trade and more general economic development policy might make it difficult and maybe even inadvisable to move too quickly towards a SADC customs union. This is not necessarily a bad thing. Allowing for different approaches provides an opportunity for countries to experiment and by so doing possibly to learn by themselves and even more so from the lessons of experience in other SADC partners. A "lowest common denominator" approach, which might result from trying to move in unison towards a customs union at this time, could hold back more progressive and ambitious countries. Countries like Mauritius can help to "raise the bar" for all SADC Member States in setting policy targets for eventual deeper integration of tariff and other trade policies.

6.3 IS SACU A MODEL?

As the oldest customs union in the world, and one that includes five SADC Member States already, SACU might be thought of as an obvious starting point and/or model for an eventual SADC customs union. However, there are a few points that might be worth considering before reaching a definitive conclusion on this.

- In some respects SACU is a customs union more in name than in fact. The infant industry protection clause, for instance has resulted in the erection of significant intra-SACU import duties in order to achieve industrial policy goals of questionable value, even for the countries imposing them. Members have also imposed various kinds of import licensing constraints and quantitative restrictions, including outright bans on imports of a number of other products for similar protective purposes, often with no consultation and little or no advance notice. All intra-SACU imports are subject to complete customs control by each country, with intra-SACU trade being subject to inspection and documentation on each side of all borders.
- The mutually agreed and signed revised SACU Agreement of 2002 called for joint decision-making on all MFN tariff decisions. Until now, however, no SACU wide tariff body has been set up for this purpose, and South Africa continues as *de facto* arbiter on tariff policy. The EPA negotiations revealed potentially serious differences among SACU members and at the very became a major source of conflict among them.
- The SACU revenue sharing formula for dividing excise taxes and customs duties is viewed by some other SADC Member States, especially poorer ones, as a

potential model for a SADC. This is primarily because of the fact that it allocates a hugely disproportionate share of customs revenues to the four smallest members. This model is not replicable on a SADC-wide basis, nor should it even be thought of as a possible model.[25] It is not replicable because South Africa would never agree to such massive redistributions on a wider basis. The allocations to the so-called BLNS countries are based on a special long-term historical relationship, and even then it is unlikely that it would have been agreed by South Africa if they had foreseen the amounts of revenues that ended up being involved as a result of unexpected increases in South African imports a few highly taxed products, especially automobiles. More importantly, the formula that produced this result bases the distribution of customs revenues on non-dutiable intra-SACU imports rather than on taxable imports from third countries. This makes it necessary to monitor and record all intra-SACU trade, requiring the very kind of border controls that are supposed to be unnecessary in a customs union. Under the arrangement, definitions and measurement of intra-SACU trade have also become a source of conflict; and in the longer run it is becoming apparent that the formula results in unpredictable and highly variable revenues for the BLNS, creating serious fiscal problems for at least the poorer of these countries.

There certainly are lessons to be learned from SACU. But there is some question whether it is necessarily an appropriate starting point or model for a SADC customs union, at least in its present form.

6.4 WHAT PERFORMANCE INDICATORS ARE APPROPRIATE FOR SADC?

Since 2007 SADC has been conducting annual "trade audits" to monitor intra-SADC trade and the extent to which Member States are meeting agreed schedules for preferential tariff phase downs. Despite chronic weaknesses in some of the basic underlying data, this has been a useful exercise. In the absence of reliable aggregate data, examples and "case studies" from on-site visits to Member States have turned out to be valuable sources of information on how SADC is actually working. But this kind of investigation requires more resources than are needed for simple aggregate data analysis.

SADC has also undertaken a number of surveys of NTBs to intra-SADC trade.[26] This research has revealed a large number and wide variety of NTBs.[27] SADC has recently joined COMESA and the EAC in setting up a tripartite NTB reporting mechanism under which the private sector can register complaints about NTBs in the region. This has revealed a wide variety of NTBs across a broad range of sectors (Charalambides 2010).

There has been considerable progress in implementing tariff phase downs; a number of countries have significantly reduced the incidence of NTBs and have begun implementation of commitments on measures such as SADC-wide quality standards. Nevertheless SADC is far from meeting the goals agreed in the Trade Protocol of increasing tariff-free trade, reducing the number of NTBs and refraining from

[25] See Flatters and Stern 2005 and 2006b for elaboration of the discussion in this paragraph.
[26] See Imani Development (2007) "Inventory of Regional Non Tariff Barriers: Synthesis Report" as one example.
[27] See Charalambides 2010 for a recent survey and summary.

imposing new ones.

The approach to monitoring progress in SADC so far has been largely “legalistic”—focusing on the extent to which countries are meeting agreed liberalization commitments and finding specific areas in which new or improved negotiated commitments are necessary. Keeping track of progress in meeting official SADC policy commitments, of intra-SADC trade, of troublesome NTBs, etc. are all important. But it is critical as well not to lose sight of the broader purpose of SADC integration—it is part of a much larger project to improve productivity and competitiveness of SADC Member States so that they can integrate more effectively into the global economy.

Monitoring of intra-SADC trade and of compliance with negotiated commitments might be helpfully complemented by a new and possibly much less “coercive” attempt to monitor progress in improving international competitiveness. Benchmarking success stories and identifying ways in which they can be extended and generalized could be very useful to all Member States.

This change of focus might lead to subtle and maybe not-so-subtle changes in the way that SADC institutions operate. At the risk of oversimplification, SADC appears to operate now at two different levels. At one level it is dominated by high level political visionaries guided by dreams of and plans for developing a greater southern Africa and ultimately a more unified and successful African continent. At another level, on a day-to-day basis, it is dominated much more by trade negotiators, who tend to see “concessions” on the use of tariffs, NTBs and other economic instruments as a surrender of sovereignty. They tend to view their main goal as to achieve openings in external markets for domestic industries and service providers. They do not tend to see trade liberalization as part of a more general program to promote economic development by improving global competitiveness.

Unfortunately this is not uncommon. Trade negotiations are often driven by a mercantilist fiction, that imports are an evil to be avoided and that trade is a zero sum game. In fact most of what trade negotiators deal in are issues that can best be resolved at home, through domestic, unilateral trade policy reform. Most of what is needed to improve any country’s business environment and international competitiveness can be done at home. It does not have to be “negotiated” with other countries.

The one strong argument for pursuing domestic reform through international negotiations is that this might be necessary to overcome domestic resistance to reforms—from domestic interests that benefit from the lack of competition and other privileges that arise from restrictive trade policies. Maintaining the fiction that domestic reform is part of the price to pay for obtaining similar “concessions” by foreign partners is seen as a way of overcoming domestic opposition to our own reforms. A necessary condition for this approach to be valid is that the negotiators actually see through this fiction and recognize domestic reform for what it is—an opportunity to enhance development prospects through improved competitiveness. In SADC and in many places elsewhere in the world, unfortunately this is not necessarily the case. Negotiators see themselves primarily as representatives of domestic interests that might be negatively affected by trade reform; their main

“stakeholders” are often perceived to be existing investors and producers that benefit from current trade restrictions, and not future investors, producers, workers and consumers that will benefit from improvements in the business environment arising from trade reform.

This might be changed by some broadening of the focus of SADC itself—working together not so much to promote trade reform and trade negotiations as goals in themselves, but rather to identify and deal with the real constraints to growth. This does not necessarily require everyone to move at the same pace. Countries that wish to fast track certain reforms can do so, and in the process provide valuable information and maybe even a model to partner countries on what works and what does not. Some issues will be more important and/or more amenable to change in some countries than in others.

This is not to denigrate past accomplishments or to abandon ongoing initiatives. It is to suggest, rather, the possible value of complementing past successes and ongoing efforts with a greater emphasis on monitoring and improving *competitiveness* in the region. A very first step might be to complement annual trade audits and ongoing NTB monitoring, for instance, by the launch of annual and concurrent competitiveness audits. The purpose would not be to “name and shame” individual countries or to enforce negotiated agreements, but rather to highlight lessons that can be utilized by any Member and to identify areas and mechanisms for regional cooperation for the mutual benefit of the citizens of all Member States.

Frank Flatters, Bangkok, 28 October 2010

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