southern african
UPDATE

A publication by the Trade & Industrial Policy Secretariat • JUNE 2001 • VOLUME 10

The SADC Trade Protocol: Which Way Ahead?

The SADC Trade Protocol is but one element of the strategies of Member States to benefit from the opportunities of international economic integration. Its ultimate impact will depend on whether it assists or hinders this integration process. In this edition of the *Update*, ***Frank Flatters*** reviews the likely impact of the Protocol by highlighting some of the strengths and weaknesses that have emerged in the negotiation and implementation processes to date.

There is considerable evidence about the role of open trade and industrial policies in promoting economic growth. Among the most accessible recent summaries is the report on Eliminating World Poverty by the British Secretary of State for International Development. It concludes that:

> "*Globalisation creates unprecedented new opportunities for sustainable development and poverty reduction....Everywhere it is clear that openness is a necessary - though not sufficient - condition for national prosperity. No developed country is closed. The initially poor countries that have been most successful in catching up in recent decades - the newly industrializing east Asia countries and China - seized the opportunity offered by more open world markets to build strong export sectors and to attract inward investment. This contributed, along with massive investment in education, to the largest reduction in abject poverty the world has ever seen*." (pp. 13-17)

It is far too early to make definitive predictions about the impact of the Southern African Development Community (SADC) Protocol. It will depend on how some critical issues are resolved over the coming months and years. The general review in 2004 that is built in to the Protocol itself will provide an opportunity to address problems that are already apparent and others that come to light by that time. It is important to start preparing now for this review.

The impact of the Protocol will depend on how seriously it is implemented and deepened by the Member States. If it promotes open regionalism and thereby assists in the reorientation of regional trade policies towards global integration and improving the Members' international competitiveness, it will be seen as a great contribution of regional cooperation to economic development. However, an inward-looking approach to regional integration in SADC will be, at best, unhelpful. At worst, it could retard income growth and poverty reduction in the region.

Limitations and Weaknesses

The existing agreement is limited in a number of important respects.

Tariff Reduction Schedules

The agreed pace of implementation of tariff reductions is slow. Only a very small share of reductions takes place in the first four years, and the degree of attainment of tariff-free trade is surprisingly small even after eight years. This is not serious if Member States remain committed to the Protocol, if timetables are not delayed and if final tariff targets are not weakened as implementation deadlines draw closer. In fact, by providing advance notice and plenty of time for agents to adjust, a phased implementation might be preferable to more sudden and sharp tariff reductions. However, this is true only if the schedules are adhered to and are not disrupted by special interests that gain from protection. There are, however, more serious concerns.

Non-Tariff Trade Barriers

While there are provisions for the elimination of non-tariff trade barriers, virtually nothing has been done yet to achieve this goal. Furthermore, new non-tariff barriers continue to be implemented by Member States. This is especially true of agricultural products, where new measures have included tobacco import controls and a number of non-tariff restrictions on flour, ranging from tightened SPS[1] rules to new duty deposit requirements on transit trade.

Infant Industries

There is explicit provision for continuation of infant industry protection. This is justified by the view that poor countries should be permitted to proceed more slowly with trade liberalisation than rich countries. To adhere to this view, however, would be to condemn poor countries to continued poverty as they deny themselves access to international trade that serves as an important engine of growth.

Anti-Dumping and Safeguards

Anti-dumping and safeguard measures are permitted, with no limitations beyond those imposed by the World Trade Organisation (WTO). Such protection has remained in the WTO in order for rich countries to provide ad hoc protection of certain vested interests, primarily in domestic "sunset industries". While poor countries sometimes face export barriers as a result of such measures, most of the damage has been borne by users of imported goods in rich countries. A number of poor and developing countries have now also started using this form of protection. South Africa has been a leader. Other countries in the region are also catching on, and several anti-dumping actions already have been targeted at intra-SADC trade. The fact that WTO rules permit a country to inflict damage on itself and its neighbours by disrupting trade in this manner does not recommend or require it as an instrument of trade policy in SADC.

Revenue Concerns

There has been excessive concern about revenue effects of tariff reductions. However, revenue losses should not be seen as an economic cost. They will be more than offset by gains to consumers and industrial users of imported goods. Furthermore, estimated revenue losses are small and will not be felt for many years. Any such losses will easily be made up through accelerated economic growth. Most Member States are already engaged in tax reforms that will reduce dependence on inherently distortionary import duties, in favor of more general and less costly income, sales and value-added taxes. If the SADC free trade area provides an additional incentive for general fiscal reform in the Member States, this should be regarded as a benefit, not a cost of the Trade Protocol.

Rules of Origin

Among the greatest inherent weaknesses of regional agreements is the need for rules of origin. These rules are required to determine whether goods originate in the region and qualify for preferential tariff treatment. Application of the rules ensures that non-qualifying products do not enter the region through low-tariff members and find their way into higher tariff member countries - behaviour known as "tariff-jumping" or "trade deflection".

At the same time as they perform this certification function, however, these rules of origin provide protection in the regional market for any kind of local content that is required. Since these rules are explicitly designed to protect local inputs, they have the additional effect of raising the costs and hence decreasing the international competitiveness of industries using these inputs.

The SADC rules of origin in many sectors are highly restrictive and explicitly designed to protect rather than liberalise regional industries. In order for garments to receive preferential tariff treatment in intra-SADC trade under the Protocol, for instance, it is not sufficient that they be cut and sewn in a Member State; they will have to be made from cloth originating in the region . Such requirements raise the cost of producing garments and reduce the international competitiveness of SADC garment production - a labour-intensive industry with great promise in fostering the region's development. Similar rules of origin, explicitly intended to protect upstream intermediate products, have been put in place in a wide range of sectors.

International experience, in Africa and elsewhere, shows that local content does not have to be forced through protective measures such as the SADC rules of origin. Forcing local content is more often counterproductive, by harming the competitiveness of downstream industries that are the major source of demand for local inputs.

Fostering of Protectionist Attitudes

Finally, the negotiating process itself has encouraged protectionist attitudes. The behaviour of many participants in the negotiating process is based on the view that the benefits of trade liberalisation by any Member State are enjoyed principally by other members, and that the "costs" of granting market access are borne primarily by the liberalising country. As result, negotiators feel it is their job to resist making concessions that reduce barriers to imports in their own markets.

This interpretation of the effects of trade liberalisation is contrary to economic theory and to evidence that has accumulated around the world

Risks of Regional Integration

Economic theory and international experience point to a number of risks of pursuing international integration through regional preferential trading arrangements (PTAs).

Trade Diversion

Trade diversion is the most widely recognised risk of regional PTAs. While MFN-based liberalisation (multilateral or unilateral) is generally welfare and growth enhancing, a PTA runs the danger of diverting trade away from low cost non-members to higher cost PTA members. This is due to the artificial cost advantage given by the regional preferences. The occurrence of trade diversion will be made more likely if there are substantial differences between preferential and MFN tariff rates. The main economic burden of trade diversion is borne by the country whose import patterns are distorted in this manner.

Policy Diversion

Unilateral or multilateral trade liberalisation is always economically preferable to selective preferential liberalisation. It is sometimes argued, however, that regional agreements might be easier to sell politically and hence might be a "stepping-stone" to more general liberalisation. The risk, however, is that concentration on regional and other preferential agreements might divert scarce analytical, bureaucratic, diplomatic and political resources from the goal of general liberalisation. Due to rules of origin and limited competition in a small regional market, regional PTAs can create substantial rents from so-called trade liberalisation in a regional context. The vested interests that benefit from these arrangements then become fierce opponents of more general liberalisation. In addition, as mentioned earlier, the negotiation process creates bureaucratic "industries" promoting protection rather than liberalisation. For all of these reasons, there is considerable risk that regional arrangements will lead to policy diversion away from the main goal of general MFN liberalisation.

Asymmetric Impact of Regional PTAs

Small countries generally gain more than larger ones from trade liberalisation. This is due to greater opportunities to exploit economies of scale and to the fact that they will generally have a smaller impact on prices in world markets. This is not necessarily so in the case of regional PTAs. Small, poor countries in PTAs among low- and middle-income countries generally have a relative comparative disadvantage in the kinds of manufacturing activities that are likely to be protected from rich country competition in the PTA. Therefore, much of the cost of trade diversion that occurs as a result of such a PTA will be borne by the smaller and poorer countries in the group. And most of the industrial development that results will occur in the more developed members. These effects are often further aggravated by rules of origin that protect upstream industries.

What Can be Done About These Risks?

All of these risks are real and potentially dangerous in SADC. What can be done about them? There is one simple answer - the fundamental solution for all of these risks is to ensure that regional integration does not impede progress to general MFN-based trade liberalisation in the SADC Member States. Trade and policy diversion, which are central to the risks identified here, will be minimised if MFN-based trade barriers are reduced simultaneously with (or even ahead of) regional trade barriers. To minimise the risks and maximise the opportunities of international integration, SADC must be part of a more general strategy to increase the participation of Member States in the global economy.

The Way Ahead

The Protocol can make a major contribution to sustainable and equitable development of Member States. For this potential to be realised, there must be re-commitment of SADC members to implementing, deepening and extending measures agreed under the Protocol. This must be accompanied by equally strong initiatives in more general MFN trade liberalisation and domestic market reforms. Such policies are the responsibility of the individual Member States. This is appropriate, since the principal beneficiaries of SADC and of the complementary reforms will be the citizens of these Member States.

The entire SADC market is very small - smaller than Turkey. An inward-looking strategy based solely on preferential access to this market is doomed to failure. To achieve sustainable and equitable development of the Member States, the SADC Trade Protocol must be part of a broader strategy of integration with the global economy to improve regional competitiveness. This outward-looking approach to regional integration is generally described as "open regionalism."

Failure to embrace open regionalism is dangerous. At best, it will make SADC irrelevant to the Member States. At worst, if the Member States embark on an inward-looking strategy for regional integration, they may be drawn into an economic dead-end that will seriously impede the development prospects of their citizens.

Many of the elements of an outward-oriented strategy are foreseen in the Trade Protocol. Harmonisation of Customs and cooperation in improving other parts of the machinery and regulatory framework of the trade infrastructure in the region, for instance, can play a major role in achieving the goals of international integration of the SADC countries. Removal of other non-tariff trade barriers will have similar effects.

The Africa Growth and Opportunity Act (AGOA) comes at a fortuitous time for SADC. By providing broad, secure and preferential access to the US market for eight years, it sends a signal about the benefits of global integration and provides strong incentives and opportunities to improve the region's competitiveness in the world market. There are already encouraging signs of the response of foreign and domestic investors in accelerating industrial restructuring processes in the textiles and garments sectors in a number of SADC countries. Policies to deepen SADC integration will give all Member States a major advantage in capitalising on the opportunities provided by AGOA.

The challenge for SADC is to improve the regional and domestic policy environment to capitalise on global opportunities and on global investor interest in the region as a desirable production location. Trade policies, and the Trade Protocol in particular, are an important element of such a strategy.

The scheduled review of the Trade Protocol in 2004 will be an important landmark for judging progress to date and for considering changes in the strategy and implementation schedule. This will provide an occasion to review not only tariff reduction schedules and progress in achieving other trade facilitation goals, but also to re?examine the rules of origin. The magnitude, incidence and economic benefits and costs of the often sizable economic incentives provided by these rules have scarcely been considered in the negotiation to date.

Other issues requiring consideration as part of the 2004 review include progress in tax reform to lessen the budgetary impacts of revenue losses that will arise from tariff reductions, and development of dispute settlement procedures.

A more ambitious review process would include revising or even removing some of the measures for dealing with anti-dumping and safeguard actions, and for providing special protection for infant industries.

It is equally important that the Member States look "beyond SADC". Most important in this regard is a continuation and deepening of the commitment of Member States to the MFN-based trade liberalisation process and to the continuation of market-based economic reforms.

Endnote

1 Sanitary and phyto-sanitary standards, refers to measures aimed at preventing the spread of disease and other threats to animal and plant life.

Frank Flatters is Professor of Economics at Queen's University, Kingston, Canada (ff@thai.com). This note is a summary of paper prepared under the USAID/RCSA SADC Trade Protocol Project. The views and opinions expressed here are those of the author and should not be attributed in any way to USAID, the US Government, SADC and its institutions, or any other agency or individual. Comments and suggestions are most welcome.