SACU Revenue Sharing:
Issues and Options

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1 Introduction

After eight years of negotiations the new SACU agreement was finalized in late 2002. It was ratified by all members and came into effect the following year, and the revenue sharing formula (RSF) was implemented for the first time in 2005. Immediate "data problems" related to implementation of the RSF have brought to light some more serious issues with the design of the formula and more fundamentally with some of the underlying assumptions and expectations about short and longer term fiscal relationships between South Africa and its smaller and less well developed BLNS partners.

The problems that have arisen reflect in large part issues that were too "sensitive" or "difficult" to address in the course of the negotiations and that were finally swept away through a variety of *ad hoc* arrangements. While this might have been necessary to reach some kind of agreement, it was almost inevitable that the compromises between different interests and with economic logic would undermine the long-term sustainability of the agreement. The fact that things have begun to unravel so quickly may be a bit surprising and disconcerting. Nevertheless, this might provide the incentive necessary for all parties to engage in serious discussions that finally face up to the problems that were swept aside previously.

The purpose of this report is to provide an overview of the key issues and an analysis of the main costs and benefits of the current arrangement.

2 Key Features of the New Agreement

There are two key features of the new SACU agreement that relate to the current problems:

- the provisions for joint decision-making and consultations on tariff policy and excise taxes, and
- the new revenue sharing formula that determines the division of net customs revenues and excises.

2.1 Joint Decision-Making

There is very little coordination on the determination of excise taxes, with the South African Treasury taking a clear lead in adjustments to the SACU excise tax. There are some complaints about lack of consultation with BLNS partners, but this does not appear to be a major issue at this time.

There are more serious problems and delays in implementing the new coordination mechanisms for tariff policy. Joint decision-making bodies for tariffs are not yet in place, leaving a potential legal policy vacuum. There have been provisional agreements for South Africa's ITAC to continue to operate as previously, issuing decisions on tariffs, dumping and other trade remedies, etc. until the new institutions are operational. Questions remain, however, about the legal status of this interim agreement and whether or for how long it will be in force.

While delays in implementing the coordinating institutions are certainly a problem, these pale in comparison to the difficulties that will arise if and when joint trade policy decision-making actually begins to take place. This is primarily because of the perverse incentives, especially for the BLNS, created by the new revenue sharing formula, which might make economically sensible trade policy decision-making almost impossible (see section 3.3. below).

2.2 Revenue Sharing

Excises: Most of the excise pool is distributed according to members' GDPs and is thus distributionally neutral. A small share (15 percent at present) is reserved as a "development component." The development component is designed to account for differences in per capita income, but these differences are grossly deflated by an adjustment factor that ensures that each country receives near equal shares (20 percent). Despite this adjustment, the development component

does have a very strong redistributive impact (on a per capita basis) in that it reallocates revenues from the one large member (i.e. South Africa) to smaller and generally poorer ones (the BLNS).

Tariff Revenues: The distribution of SACU tariff revenues according to members' shares of intra-SACU trade is quite peculiar and certainly differs from the standard practice of distributing according to duty collections on each country's dutiable imports—i.e. according to their contributions to the revenue pool. Among other implications of the SACU formula is the requirement to monitor and keep records of trade among SACU members, necessitating border controls whose elimination is usually one of the main goals of a customs union.[1] The most common argument given in support of this arrangement is that it compensates the BLNS for the "cost raising impact" of a tariff that has been designed primarily for the protection of industries in South Africa. We examine the empirical basis for this claim in a later section.

Since the much smaller BLNS members have much higher propensities to import, especially from South Africa, the main impact of the formula is to redistribute tariff revenues from South Africa to them. The principal reason for its adoption is that it "worked" inasmuch as it fortuitously provided the BLNS with basically the same implicit revenue transfers as they had been receiving under the old agreement. Its main benefit for South Africa is that it put a cap on the amount of transfers required under the agreement. In particular it ruled out the possibility that South Africa would be required to transfer more revenue than was generated by the SACU tariff—a real and growing possibility under the old agreement.

Table 1 shows the current distribution of revenues under the revenue sharing formula, together with some indicators of the importance of these revenues in each of the SACU Member States. The Governments of Swaziland, Lesotho and Namibia are dependent on SACU for an exceedingly high proportion of total revenue; the situation is a little better in Botswana. The customs component is by far the largest share of the SACU payment. It is the customs revenue provisions that have become the main source of concern in implementing the new agreement and this is the principal focus of attention in the next section.

Table 1. Receipts from SACU Revenue Pool, 2006

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

Source: The World Bank *African Economic Indicators 2004* and budget documentation from the five member states.

3 Problems Arising from the New Agreement

3.1 Questionable Trade Data

The first issues to arise in implementing the new revenue sharing formula were perceived as technical and definitional "data problems."

These data issues have attracted considerable discussion over the past two years. Among the main issues have been the reconciliation of *cif* and *fob* import values, the definition and measurement of re-exports that are supposed to be excluded from "intra-SACU imports," the handling of non-reported

[1] SACU is no different in this regard. The new SACU Agreement explicitly describes facilitation of trade within the union as a primary goal.

trade at certain border posts and with individual travellers, reconciliation of electronic data from different data systems used in different Member States, and determination of the distinction between imports of goods (included in the definition of intra-SACU imports) and imports of services (excluded from intra-SACU imports).

It soon became apparent, however, that behind these "data problems" are some more fundamental economic issues arising from the nature of the revenue sharing formula. It is these systemic issues that must be dealt with in order to come to solve the problems that have arisen in implementing the new agreement. The following subsections review some of these key issues.

3.2 Fundamental Source of Conflict

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

3.3 Customs and Trade Facilitation

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

3.4 Perverse Incentives for Trade Policy—Tariffs and Rebates

The combination of joint decision-making and the peculiar distribution of the customs pool creates some new and perverse incentives for tariff policy in SACU.

Tariff-setting decisions generally involve trade offs among the interests of consumers and users of protected products, producers of these products, and the Treasury. The new revenue sharing formula changes this calculus in peculiar and different ways in South Africa and in the BLNS.

The BLNS, with few producer interests in traditionally protected industries, have generally argued against SACU tariffs on most goods. From their perspective, it is the consumer/user interest that has quite naturally dominated such discussions. The new formula turns this traditional BLNS calculus on its head. The BLNS now gets not only the tariff revenues on their own imports of protected goods, but also a large share of the revenues collected on South African imports. In most cases this revenue interest will dominate downstream user and consumer interests in tariffs. The BLNS now have a strong economic and financial interest in maintaining and maybe even increasing the import tariffs that they traditionally had opposed.

Table 2 shows the distribution of the revenue costs of a R2 billion reduction in the customs revenue pool as a result of some form of trade liberalization. Most of the costs are borne by the BLNS, with their share of the revenue loss ranging from 29 percent for Botswana to 14 percent for Lesotho.

Table 2: Distribution of Revenue Losses from a R2 Billion Reduction in Duty Collections

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

Source: Authors' calculations.

The effect on the South African calculus is the opposite. South Africa bears only 12 percent of the revenue loss from any fall in the customs pool. Since most of the import duty collections now go to the Treasuries of the BLNS, the revenue impact of tariff decisions no longer needs to be an important consideration for South Africa. This would seem to present an ideal opportunity to rationalize the tariff structure, and especially to reduce outstanding tariff peaks on products such as motor vehicles, garments and any other sectors where imports are significant and thus consumer/user interests dominate those of protected producers. Not only will tariff reductions in such sectors have their normal welfare and efficiency enhancing effects, but there also will be very little pain in terms of foregone revenues.

The real problem is that the sharing of tariff-setting responsibilities is likely to give the BLNS an effective veto over any tariff reductions, and it will now be in their interest to do so. The new revenue sharing formula threatens to make it difficult to engage in any further serious tariff reform in SACU. It has turned the greatest foes of the SACU tariff into its greatest supporters. It has given them a veto to protect their new and perverse economic interests. And it is likely to deprive South Africa of the opportunity to take advantage of a unique opportunity and increased incentive to engage in serious tariff reform.

Just as they benefit disproportionately from increases in tariff revenues, the BLNS also pay a disproportionate share of the costs of any South African duty rebate schemes.

The previous table also applies to the case of, say, a R2 billion duty-rebate scheme for clothing and textile exporters. This would be small compared to the actual rebates already provided as an incentive for South African car exports. Almost all (88 percent) of the loss in customs duties is borne by the BLNS, while large South African producers are the primary beneficiaries of the resulting export support. The BLNS carry most of the fiscal cost of such duty rebates and must still bear the cost raising impact of tariffs on South African products as well as third-country imports. This surely will be a source of contention in the review of South Africa's Motor Industry Development Program (MIDP) and in the design of any future rebate programs.

The same general argument applies to rebate programs employed by other SACU Members. Any SACU member could have provided the rebate examined in Table 2 and the distribution of the costs would be the same. BLNS members would bear only 14 to 29 percent of the fiscal costs of any such measures under the current revenue sharing formula (see final column of Table 2).

Most of the revenue costs of any duty rebate program are borne by countries other than the one employing the rebates. Taking account of the fiscal externalities of members' rebate programs will be a difficult and highly contentious task. The only sure way to avoid it is to agree on a more effective mechanism for fiscal redistribution in SACU; or to agree on a more effective mechanism for tariff-making.

3.5 Perverse Incentives for Trade Policy—SACU Expansion

Whatever its shortcomings, SACU is still one of the longest standing regional economic schemes in the world. As a result, further expansion is a topic of real interest to SACU's existing members and a number of other countries in the region. The new agreement makes explicit provision for the entry of new members. Unfortunately, the current revenue-sharing formula, at least as it applies to customs revenues, creates some very perverse incentives for existing members in considering possible additions to SACU membership. The formula would encourage existing members to resist extending membership to a country to whom they export a lot (i.e. whose intra-SACU imports are higher). They are also likely to resist ways to increase imports from new members. From a fiscal perspective, the formula makes the best candidates for new membership those that trade very little with the existing members (i.e. that would not claim much from the SACU customs pool) and that continue to import largely from the rest of the world (i.e. raise the size of the revenue pool). This is certainly contrary to the intention of SACU to promote regional trade and economic integration.

A more fundamental question about the revenue sharing formula is whether it is really appropriate or sustainable in any sense in an expanded SACU. This particular formula was designed to achieve some particular political purposes in a particular historical context. It is difficult to imagine that South African taxpayers would be willing to make financial transfers of similar orders of magnitude to new SACU members (or that new members would be willing to make such transfers to the BLNS if the formula worked out that way). Before discussions of SACU expansion bring such issues to the fore, it might be preferable to separate the issue of customs revenue sharing from that of income transfers to neighboring countries bound by and based on longstanding economic and political ties.

3.6 Predictability and Stability

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

4 Benefits and Costs of SACU: RSA and BLNS Perspectives

Discussions of the economic costs and benefits of SACU normally focus on a few key issues. The two most frequently cited ones are the cost-raising or polarization effects of SACU, and the burden (or benefits) of fiscal transfers. Because of their importance and their close inter-relationship we deal with them first. A less-discussed but no less important issue, especially in the longer run, is the inevitable decline in the importance of import tariffs as a source of government revenue in SACU as a result of general trade liberalization and the negotiation and implementation of various preferential trade agreements.

4.1 Cost-Raising Impacts of the SACU Tariff

The cost-raising argument is that the SACU tariff protects South African industries at the expense of SACU consumers.

There can be little doubt that the structure of the SACU tariff has historical links to South Africa's import substitution policy. The tariff structure has been rationalized over the past decade and a half, but there remains considerable room for further liberalization. There are three major costs of the tariff.

- It encourages high cost and inefficient production, diverting resources into activities that raise costs and reduce competitiveness of domestic producers. Except in sectors benefiting from export subsidies, most importantly the motor industry, it discourages the development of export industries.
- It encourages rent-seeking behaviour, diverting entrepreneurial and policy-making energies from investing in measures to increase competitiveness to seeking and designing favours from government.
- It raises consumer prices.

Since few of the protected producers are in the BLNS countries, the main impact of the tariff from the BLNS perspective is its cost-raising impact on consumers. This would include, of course, potential industrial "consumers" of raw materials and intermediate inputs protected by the SACU tariff.

The consumer cost of the tariff is independent of whether the protected goods are made in South Africa or imported from elsewhere. In either case the prices paid in the BLNS reflect the cost-raising impact of the tariff.

Before concluding that this is a legitimate cost to the BLNS of SACU membership, it needs to be determined how the BLNS would collect government revenue in the absence of SACU. They would almost certainly depend at least part and most likely in very large part on import duties. The cost-raising impact of the SACU tariff, therefore, is really the net effect of the *difference* between tariff structures that would be put in place by independent BLNS states and those in place under SACU.

There certainly would be room, in the absence of SACU, for the BLNS to design more rational and less distorting tariff structures than what is now in force under SACU. Tariff peaks in sectors such as garments and automobiles could be cut. The number of tariff bands could be reduced and differences in rates between consumer, intermediate and capital goods could be narrowed, with the net effect of reducing rates on consumer goods. Such tariff reforms might have an overall impact of lowering the cost-raising impact of import tariffs.

However, fiscally independent BLNS countries would almost certainly have to depend to a greater extent on tariffs than does SACU at the moment, and this would require higher average rates than exist now in SACU. Certainly, if the BLNS wished to generate revenues similar to what they currently receive from import duties under the revenue-sharing formula, they would have to impose substantially higher rates (and it might actually be impossible). If they could not or chose not to generate as much as this through import duties, they would have to impose and/or increase other taxes and these would have their own economic costs.

In sum, the "cost-raising" effects of the SACU tariff are more complex than generally portrayed and need to be measured by comparing the existing SACU tariff structure with the tax and tariff structures that each of the BLNS would put in place if they were not part of SACU. The exact cost-raising impacts could vary by sector and could be positive or negative, overall and in any sector. If there are significant cost-raising effects, most of them would be concentrated in a few sectors (garments and motor vehicles) and overall they would be much lower than generally claimed. As will be seen, even in the absence of redistribution under the current revenue sharing scheme, the costs-raising story, at least at the aggregate level, is largely a myth. When the redistribution effects are taken into account, it turns out that the net effect of the SACU tariff is a very large redistribution in favour of the BLNS.

Any attempt to measure the net cost-raising impact of the tariff needs to start with some determination or hypotheses about how each of the BLNS members would change the SACU structure if they were free to do so and were not members of SACU. It is critical to note that, for reasons discussed already, this is very different from the question of what tariff structure they would argue for as members of SACU under the existing revenue sharing formula. The current revenue sharing formula provides extremely perverse incentives to the BLNS in this regard.

An accurate accounting of the cost-raising effect of the SACU tariff requires a number of distinct calculations. The first step is to estimate the "gross cost raising effect" without taking account of

either the alternative revenue raising measures the BLNS would put in place in the absence of SACU or the compensating effects of the transfers under the revenue sharing formula. This appears to be the measure most observers refer to (incorrectly) when discussing to the "cost raising impact" of the tariff.

The gross cost-raising effect of the tariff is the direct impact of the SACU tariff on prices in the BLNS. It is the difference between prices faced in the presence of the tariff and those that would prevail in its absence.

Suppose that the full amount of the tariff is passed on to final users and consumers of tradable goods. Then the gross cost-raising effect on any tradable good is the sum of the price increasing effect of the tariff on imports from all sources (intra- and extra-SACU) and the import parity pricing effect on any locally produced import substitutes for the same product. If the good in question is an intermediate input, the cost-raising effect of the tariff could be offset by rebates, as would be expected in the case of inputs into goods produced for extra-SACU export. When the inputs in question are used to produce tradable goods sold in the SACU market, the cost-raising impact is ultimately determined by the tariff on the final good in question. And when they are used to produce domestic non-tradables, it is simplest to assume that the full amount of the tariff is passed on to final users of the non-tradables.

Upper and lower bound estimates were made of the aggregate gross cost raising effect of the current SACU tariff. The estimates generally err on the side of higher rather lower cost raising impacts. In some cases several different assumptions were made and differences between the upper and lower bounds arise from these different scenarios.

- Difficulties in deriving *ad valorem* equivalents of specific and formula duties made it necessary to make some assumptions. If a formula included an *ad valorem* component in a "maximum of" format, the *ad valorem* rate was used. If there was no *ad valorem* the equivalent rate was assumed to be a rather high 25 percent.
- The data were often incompletely disaggregated, with the result that trade data were sometimes reported for aggregates with more than one tariff rate. In such cases two cost raising estimates were made—a minimum and a maximum corresponding to the minimum and maximum tariff rates applicable within the group.
- To take partial account of the relief from cost raising effects of tariffs available to exporters a separate estimate was made under the assumption that all yarn and cloth imports were exempted from the SACU import duty.

Probable and possible estimates of aggregate cost-raising effects of the SACU tariff in each of the BLNS Member States are shown in the first two columns of Tables 3 and 4. These represent the most likely and highest possible price raising impact in each Member State across the range of scenarios considered.

Table 3 presents estimates of the cost-raising impact of the SACU tariff on the BLNS as a percentage of the value of each country's imports and Table 4 in billions of Rands. Since the entire analysis is conducted under assumptions that err on the side of finding high cost-raising effects,[2] it is our judgement that the actual gross cost-raising impact of the SACU tariff is much closer to the "probable" than to the "possible" estimates shown here. Taking account of all of the data weaknesses and making the most pessimistic possible assumptions, it is conceivable that it could get as high as the "possible" estimates, but this is very unlikely. Most of the following discussion will be based on the "probable" estimates shown in the tables.

[2] It is assumed, for instance, that goods imported under EU and SADC preferences are priced up to the SACU MFN tariff, so that none the gains from such tariff preferences are passed on to SACU consumers.

Table 3. Gross Cost-Raising Impact of SACU Tariff
(% of value of total imports, 2006)

	Cost-Raising Impact		Customs Transfer Under SACU RSF
	Probable	Possible	
Botswana	9.2	14.8	17
Lesotho	9.6	16.6	20
Namibia	7.4	15.1	32
Swaziland	7.9	14.1	21

Source: Authors' calculations.

Table 4. Gross Cost-Raising Impact of SACU Tariff
(R billion, 2006)

	Cost-Raising Impact		Customs Transfer Under SACU RSF
	Probable	Possible	
Botswana	2.3	3.7	4.6
Lesotho	0.9	1.5	2.2
Namibia	1.0	2.1	4.6
Swaziland	1.0	1.8	3.0

Source: Authors' calculations.

Table 3 shows the cost-raising impact of the SACU tariff probably lies between 7.4 and 9.6 percent of the value of total imports of the BLNS states. Measured in this way, the cost-raising impact is largest for Lesotho and smallest for Namibia. Differences across countries reflect differences in the composition of their imports, with Lesotho's and Botswana's more heavily concentrated in goods with higher SACU tariff rates than in the cases of Namibia and Swaziland.

Table 4 shows the same estimates, except that they are measured in absolute terms, in billions of Rands. Differences across countries now reflect not only differences in the composition of their external trade but also in the sizes of their economies and in their propensities to import. By this measure Botswana suffers the largest gross cost-raising impact (R2.3 billion), and the other three members' face almost identical effects of about R1 billion.

How do we move from *gross* to *net* cost-raising impacts? We present two different measures of the net cost raising effect of the SACU tariff. The first is the cost raising impact of the tariff *net of compensation provided currently through the sharing of the SACU customs pool*.

The final columns of Table 3 and of Table 4 show the estimated transfer of customs revenue to each of the BLNS members under the current revenue sharing formula. In all cases, the customs revenue transfer far exceeds the gross cost raising impact of the SACU tariff. This remains the case even under the most pessimistic assumptions about the gross cost raising impact (see the "possible" cost raising impact in Tables 3 and 4). This means that, however estimated, the net cost raising impact of the SACU tariff under the current revenue sharing impact is actually negative.

Table 5 shows the net-of-compensation cost raising impact, based on the "probable" cost-raising estimates. In all cases the net cost raising effect is negative. That is, the customs revenue transfer provided to each of the BLNS under the revenue sharing formula is more than enough to compensate for the gross cost raising effect of the SACU tariff. The final column shows the ratio of the revenue sharing transfer to the gross cost raising effect of the tariff. The size of the revenue transfer ranges from twice (Botswana) to four and a half times (Namibia) that of the gross cost raising effect. The BLNS are more than adequately compensated for any cost raising impacts of the SACU tariff.

Table 5. Cost Raising Impact of the SACU Tariff Net of Customs Revenue Sharing

	Gross Cost Raising	RSF Customs Transfer	Net Cost Raising	RSF Transfer/ Cost Raising Ratio
	(R billions)			
Botswana	2.3	4.6	-2.3	2.0
Lesotho	0.9	2.2	-1.3	2.5
Namibia	1.0	4.6	-3.6	4.5
Swaziland	1.0	3.0	-2.0	3.0

Source: Gross cost raising effect based on authors' calculations; customs transfer data from National Treasury.

A second way to think of the net cost raising impact of the SACU tariff is to compare its gross cost raising impact with that of the tariffs that would have to be levied by each of the BLNS members to maintain revenue neutrality in the absence of SACU. Revenue neutrality can be thought of either in terms of the tariff needed to collect the same revenue on each country's imports as is collected on these imports currently, or as the tariff that would be required to generate the same revenue in each of these countries as is now being received through the customs revenue sharing arrangement.

Both of these net cost raising impacts can be determined without any further calculations.

To raise the same amount of revenue as is currently collected on their own global imports, each of the BLNS members would have to levy a trade-weighted tariff equal to the rates shown in the first column of Table 3. This is exactly the aggregate cost-raising impact of the current SACU tariff. This means that the revenue neutral (in this sense) tariff would have exactly the same aggregate cost raising impact as the current SACU tariff. While abandoning the SACU tariff would have a cost reducing effect, generating the same amount of tariff revenue would require levying a tariff with same average rate. In other words, using this definition of revenue neutrality the net cost raising impact of the SACU tariff is zero.

Of course, the same revenue could be raised with many different tariff structures as long as they had the same average rate. Unburdened by the protectionist pressures faced in South Africa, the BLNS might be better able to devise a more rational tariff structure with a more uniform and thus less distorting rate structure. While the distribution of the cost raising impact across imports and consumers might change, the aggregate gross cost raising impact would be the same and the net cost raising effect would be zero.

A more relevant definition of revenue neutrality for the BLNS, at least in the short and medium terms while other tax mechanisms are developed and improved, would be a tariff structure that raised the same amount of revenue as is currently received under the combined SACU tariff and customs revenue sharing arrangement. Having to rely on tariffs levied only on their own imports, the BLNS would have to levy sharply higher rates than are currently imposed by SACU.

To achieve revenue neutrality in this sense in the absence of SACU, the trade weighted tariff rates would have to be increased from those shown in the first column of Table 3 to those shown in the final column. Moving out of SACU would have a net cost raising impact equal (but opposite in sign) to the amounts shown in the third column of Table 5. In other words, by this definition of revenue neutrality, under the current revenue sharing formula SACU has a substantial cost *reducing* impact on the BLNS (the gross customs transfer to the BLNS exceeds the highest possible cost of the tariff on consumers in these countries).

South African consumers and users of tradable products also suffer, of course, from the cost-raising impact of the SACU tariff. Just as with the BLNS, the question from a South African perspective is whether they would suffer more or less from this effect in the absence of SACU.

The new SACU Agreement has a profound effect on this question. Prior to the new agreement, the SACU tariff was really the South African tariff and was entirely at the discretion of the South African authorities. There was no basis for South Africa to complain about its cost-raising effects. Under the new agreement the tariff is meant to be jointly determined, and any Member State has a veto over proposed tariff changes.

Suppose now that South Africa wishes to reduce the tariff on garments or motor vehicles. As observed earlier, the new revenue sharing formula creates a very strong incentive for BLNS members to oppose such a change, despite its beneficial impact on their own consumers. This is because their revenue losses would far exceed the benefits for their consumers. If they did veto such tariff reductions, should they not be asked to compensate South African users of the products in question for the cost-raising effect of the vetoed tariff reductions?

The same considerations would apply in considering the effects of the use of trade remedies such as anti-dumping duties by any of the BLNS members.

In summary, the standard argument about the "cost-raising" impact of the SACU tariff suffers from two flaws.

- ***It ignores the fact that in the absence of SACU the BLNS would almost certainly have to raise revenues through import duties. A revenue neutral import duty (i.e. one that raised the same amount of revenue as each of the BLNS countries currently "contributes" to the customs pool) would have the same cost-raising impact as the SACU tariff.***
- ***It does not take account of the distribution of customs revenues under the current formula, which provide far more than adequate compensation for any "cost raising" effects of the current tariff.***

In reality, therefore, the "cost-raising impact" of the SACU tariff under current arrangements is actually a cost-reducing and welfare enhancing effect for the BLNS.

4.2 Polarization in SACU

Discussions about polarization are based on the substantial differences in per capita incomes, growth rates and other development indicators among the SACU Member States. The persistence and in some cases widening of such differences are seen as signs of polarization of economic development within SACU, with large and relatively well developed South Africa continuing to develop at a much faster pace than its smaller and poorer neighbours.

These observations raise deep and important issues about economic development in the region. From the perspective of SACU, however, the questions can be narrowed somewhat. We concentrate here on two issues.

- What is the extent of polarization in the region, what are its patterns and is it growing or shrinking?
- What is the relevance of these facts to SACU, and what, if any, are the policy implications for SACU?

Tables 6 and 7 provide some basic economic and social indicators for SACU Member States.

Table 6. Basic Economic Indicators for SACU Members

	Population 2002	GDP 2002	Per Capita GNI 2002	Per Cap GNI Growth 1990-02	GDP Growth 1975-84	GDP Growth 1983-94	GDP Growth 1995-
Botswana	1.71	7.02	3,010	1.8	11.6	8.9	5.8
Lesotho	1.78	1.15	470	-0.5	6.7	5.4	2.7
Namibia	1.99	4.37	1,960	2.0		3.4	3.3
Swaziland	1.09	1.69	1,240	0.3	3.3	7.3	3.1
South Africa	45.35	182.28	2,600	-0.1	2.4	0.8	2.6

Source: The World Bank *African Economic Indicators 2004*

Table 7. Selected Social Indicators for SACU Members

	Life Expectancy 2002	Change in Life Expect. 1990-02	Pop'n per Physician 1990-00	Sec. School Enrollment 1995-00	Illiteracy Rate 2002
Botswana	38	-19	4,274	82	21
Lesotho	43	-16	16,436	28	16
Namibia	42	-16	3,562	60	17
Swaziland	44	-13	6,636	60	19
South Africa	46	-16	1,780	90	14

Source: The World Bank *African Economic Indicators 2004*

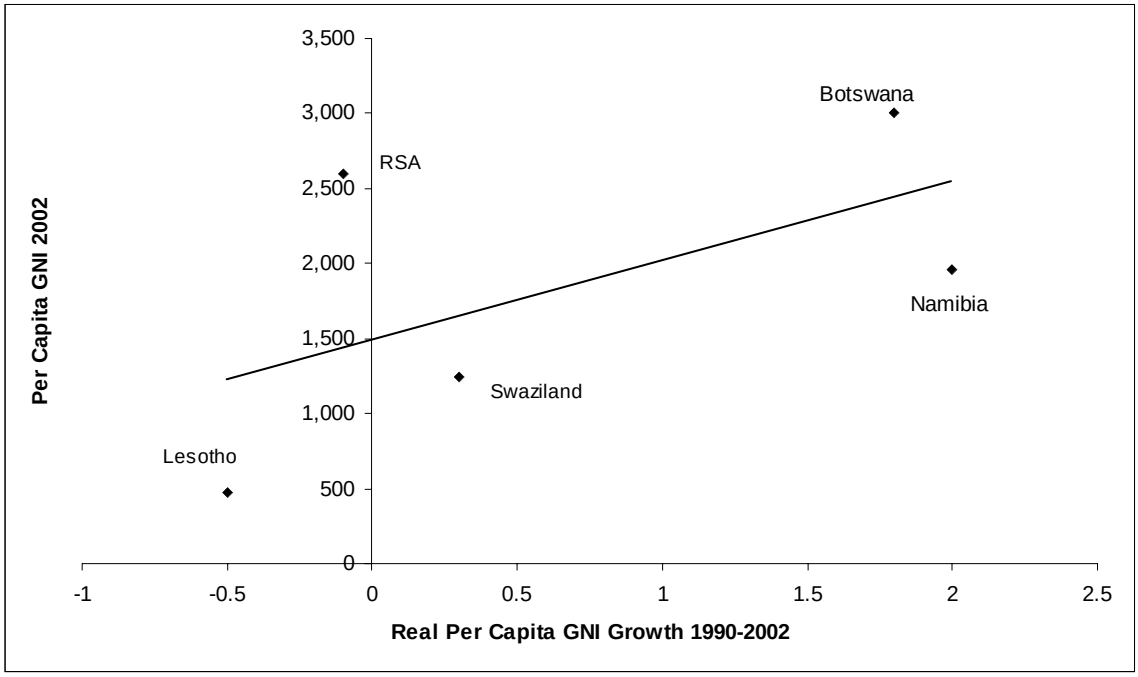
Table 6 confirms the large differences in size and level of economic development among SACU Member States. In terms of overall size, South Africa clearly dominates, accounting for 87 percent of SACU's total population and 93 percent of economic activity.

The disparities in per capita incomes are also very stark. While South Africa is a relatively rich member of the group, it is interesting to note that it is not the richest, at least according to real US dollar GNI per capita. In this regard, Botswana is SACU's richest member, with a per capita income more than 15 percent higher than South Africa's. Contrary to assumptions implicit in many SACU discussions, the BLNS are far from a homogeneous group. Lesotho is the poorest member, with a per capita income of only $470. Swaziland's per capita income is more than 2.6 times higher than that, Namibia's over 4 times higher, South Africa's over 5.5 times higher, and Botswana's 6.4 times higher.

The social indicators in Table 7 show considerable diversity among SACU members, although the patterns in these indicators do not correspond exactly with per capita income differences. The starkest example is in life expectancy. Botswana, SACU's richest Member State by income has the lowest life expectancy, only 38 years at birth. The patterns of secondary school enrolment are more closely aligned with those of per capita incomes.

Is there evidence of growing or diminishing polarization in SACU? Figure 1 provides a plot of some of the data in Table 6, showing the relationship between current per capita income levels and their recent growth rates (1990-2002). A trend line fitted to all the data points has a pronounced positive slope, indicating that, on average, members with higher per capita incomes also have had higher income growth rates. This is an indication of growing polarization—the richest members are getting relatively richer and the poorer members relatively poorer. In the case of Lesotho, the poorest member, the decline in its per capita income is not just relative, but also absolute. Its real per capita income (measured in US dollars) shrank at a rate of 0.5 percent per year between 1990 and 2002.

Figure 1. SACU Income Convergence



Source: Based on data in earlier tables.

A closer examination of the data, however, provides a more nuanced picture. In terms of performance over the past decade the SACU Member States can be divided into two groups—the strong performers and the weak performers. The two strong performers are Botswana and Namibia, with real per capita income growth of about 2 percent per year. Botswana is the richest Member State and Namibia the third richest. At the other end of the scale the three poor growth performers are South Africa, Swaziland and Lesotho. This group includes the two poorest SACU Member States as well as the largest and second richest.

Looked at another way, three of the four BLNS members have outperformed South Africa in terms of per capita income growth over the past decade, and two of them, Botswana and Namibia by a substantial margin. It is difficult to argue that there has been a clear pattern of increasing polarization recently, at least relative to South Africa. There appear instead to be three main polarization stories.

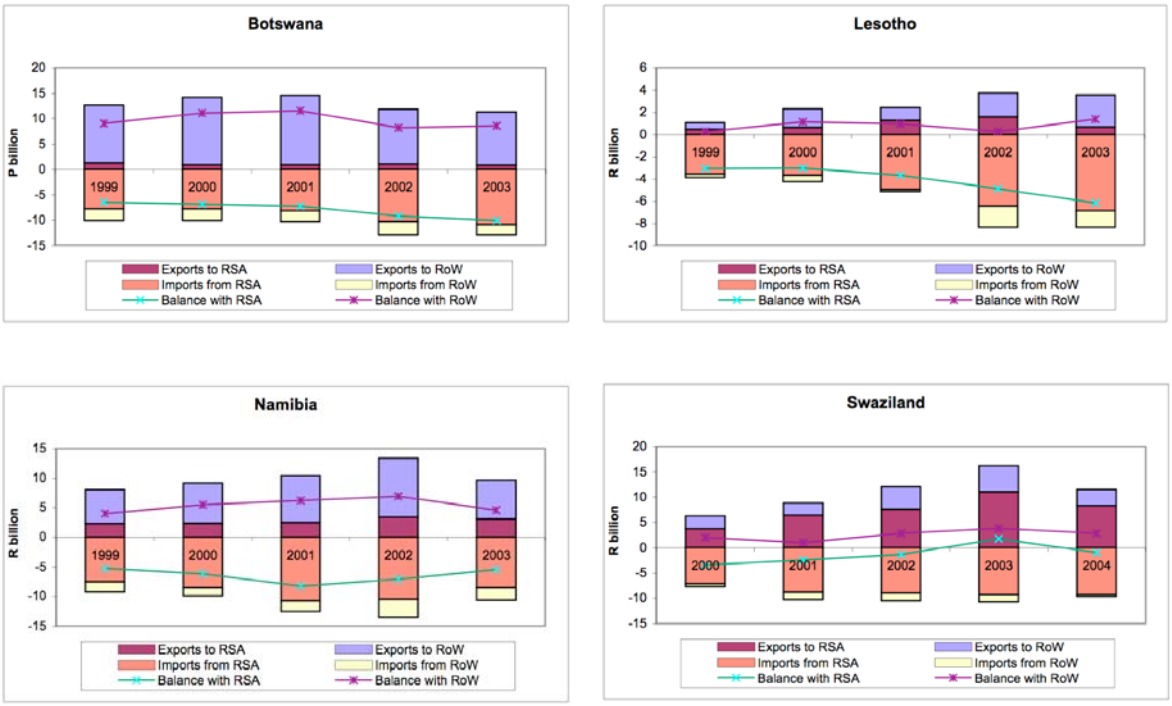
- Botswana and Namibia, the richest and third richest members have been outperforming the other three members.
- Lesotho, the poorest SACU member, has continued to perform more poorly than all the others.
- South Africa is not outperforming the rest of SACU.

What do any of these conclusions have to do with SACU? Is SACU the reason that Botswana and Namibia are outperforming the others? Is SACU to blame for the fact that Lesotho has underperformed everyone else?

The usual SACU polarization story has little to do with any of these facts. They are worth examining, however, because of the light they shed, directly and indirectly, on what actually has been happening.

The most commonly recited SACU polarization story relates to South Africa's economic domination in the customs union, as evidenced by its chronic bilateral balance of trade surpluses with the BLNS. The conclusion drawn from this is that the customs union facilitates the continuation of a structure whereby South Africa benefits from selling its products to the BLNS while the BLNS, with their underdeveloped economic structures, are unable to benefit in a similar manner by selling in the South Africa market.

Figure 2. Exports, Imports and Trade Balances of the BLNS



Source: Based on BLNS country trade data provided in TIPS SADC Trade Database

The charts in Figure 2 show merchandise imports, exports and trade balances of the BLNS *vis à vis* both South Africa and the rest of the world. It should be noted that the trade data from the BLNS on which they are based are well known to overstate the importance of imports from South Africa. Because of South Africa's role as a transport and logistical hub for the region, many of the imports reported as originating there are actually from elsewhere in the world but have been cleared for entry into SACU at the South African port of entry.

The data for all four countries show a very large apparent import dependence on South Africa. Except for Swaziland, they also show a large trade deficit with South Africa. Except for Swaziland and to a lesser extent Lesotho, South Africa is of very little importance as an export destination for these countries. All four countries have a much "better" trade balance with the rest of the world and, except for Lesotho the surpluses with the rest of the world substantially or completely offset the deficits with South Africa.

What can be read into the data portrayed in Figure 2?

It is important first to dismiss some common fallacies in interpreting this kind of data.

- Bilateral trade balances have no economic significance *per se*. To expect or to require that all bilateral trade be in balance, for instance would be to deny all the laws of comparative advantage and the reality of trade in today's global economy. As observed in describing the charts in Figure 2, BLNS trade deficits with South Africa are generally offset by trade surpluses with the rest of the world. These countries appear to have more to gain from exporting (on net) to the rest of the world than to South Africa. It would be a great economic folly to curtail these opportunities just to ensure a bilateral trade balance with South Africa.
- It is similarly dangerous to draw welfare conclusions from overall trade balances. In particular, to argue that trade surpluses are better than trade deficits is to fall into the mercantilist trap that is based on the erroneous view that exports are welfare-enhancing and imports are welfare-

reducing. The balance of merchandise trade is a summary of only one part of a country's set of economic and financial interactions with the rest of the world and depends on a variety of short and long term macroeconomic factors. While at any point in time it might be advisable to engage in policies to reduce (or increase) a country's trade deficit, to constrain the trade balance to a certain value (zero, positive or negative) as a general rule would certainly be welfare-reducing.

The biggest issue arising from the data is the apparent import dependence of the BLNS on South Africa. To the extent that this dependence is overstated and many of the imports are actually from elsewhere, then this is simply a reflection of South Africa's entrepôt role in the region. The fact that traders choose to import in this way suggests that it is less costly and more efficient to do so rather than to import directly. In this sense the BLNS benefit from being part of SACU and being able to take full advantage of these entrepôt services, unimpeded by intra-SACU import duties. This is not to say that the services could not be provided even more efficiently and that the policy choices of SACU Member States could play an important role in this regard. Improving trade facilitation at border posts within SACU could yield large dividends.

There is a real possibility, however, that at least some of the imports from South Africa represent trade diversion. The combination of the external SACU tariff and the freedom from tariffs on intra-SACU makes South African goods artificially cheaper than those imported from elsewhere, inducing BLNS importers to source from there rather than from other suppliers, even if they would be less expensive in the absence of the SACU tariff.

In normal circumstances such trade diversion is welfare reducing for the importing country, with the cost being manifested in the loss of customs revenue on diverted trade. The new SACU customs revenue sharing arrangement, however, bases the distribution of tariff revenues on intra-SACU trade. This has the peculiar effect of transferring some of the costs of such trade diversion from the BLNS importing countries to taxpayers in the rest of SACU.

Consider the case of the SACU tariff on motor vehicles. This creates a strong incentive for the BLNS to source these vehicles in South Africa rather than, say, Europe. If the South African sourced vehicle is produced in South Africa, the BLNS purchase reduces the size of the customs pool, and only part of this cost is borne by the vehicle-importing country. The rest of the cost of this trade diversion is borne by other members, with the distribution similar to that shown in the earlier discussion of the revenue gains from the SACU tariff and the revenue losses of rebates. The aggregate cost of this trade diversion is still the same. But the revenue sharing formula distributes it differently than in the case where each country collects its own import duties at its own borders.

There is also the possibility, of course, of diversion of South Africa's imports from the rest of the world to the BLNS. However, the small amount of exports from the BLNS to South Africa suggests that this is not a danger of any significant magnitude, at least in aggregate. Nevertheless, there are some particular instances in there is clear diversion of South African imports as a result of SACU. Almost one third of South Africa's intra-SACU imports, for instance, are accounted for by one item, soft drink concentrate from Swaziland. This is basically a sugar product where the absence of a tariff on intra-SACU trade makes it profitable to produce in Swaziland for export to South Africa. As a result of the SACU RSF almost 90 percent of the cost of this trade diversion is passed on to the BLNS countries (including Swaziland, of course).

Under current trade patterns at least there is little if any diversion of trade between any of the BLNS countries.

The long run solution to trade diversion in any preferential or free trade arrangement, of course, is to minimize the incentive created by high external MFN tariffs. This should start with reductions in significant tariff peaks such as on garments, motor vehicles, and other consumer goods in SACU. Once again, the customs revenue sharing arrangement creates exactly the wrong incentives for the BLNS in considering this possibility.

The real question is what is the role of SACU in promoting the economic development of its members. The SACU market is very small (comparable in size to Finland) and cannot possibly be the

primary focus of or basis for an economic development strategy. The main export markets for SA as well as the BLNS are outside of SACU. The real question for the BLNS is not so much related to potential gains from export opportunities in South Africa, but rather the extent to which SACU contributes to integration with the global economy.

Trade facilitation is far more important than the development of intra-SACU export markets. Efficient transit arrangements are essential as a means of minimizing border costs and removing costly and unnecessary impediments to trade.

In summary, the so-called polarization in SACU is a more complex phenomenon than is generally recognized. There is no clear overall pattern of increasing or decreasing polarization among Member States. The "problem" of BLNS balance of trade deficits with South Africa is largely a reflection of their healthy integration with the global economy. This is something that should be encouraged, and not hindered, by SACU policies and institutions. The SACU tariff undoubtedly causes some trade diversion, but the RSF spreads the cost of such diversion among all the Member States. The best solution to the trade diversion problem is further liberalization of the SACU tariff.

4.3 Net Fiscal Transfers

By far the largest economic impact of SACU is felt through the fiscal transfers provided by the revenue sharing formula. Redistribution is provided through the development component of the excise pool and the through the customs pool. The major part of the excise pool (85 percent of it at the moment) is simply returned to the Member States in which it was collected and hence provides no redistribution.[3]

Development Component of the Excise Pool: Aside from the small adjustment for per capita income differences the development component is basically a block transfer of the same amount to all Member States, which means that, on a per capita basis the transfer is negatively related to population and in particular that South Africa gets by far the smallest amount. But since the populations of the BLNS countries bear no particular relation to their per capita income levels, differences in the per capita transfers under the development component are not strongly related to differences in the development needs of the BLNS, at least as measured by per capita income differences. The correction for per capita income differences is meant to provide a partial correction for this deficiency.[4]

Table 8 shows estimates of the current (2006) net transfers to/from each Member State as a result of the development component (i.e. the difference between their contributions to this part of the revenue pool and their receipts from it). Is the redistribute pattern progressive in the normal meaning of the term; i.e. does the formula redistribute from richer to poorer members? One anomaly is that Botswana, SACU's richest Member State on a per capita income basis, is a net recipient rather than donor. On the other hand, within the BLNS group the pattern appears to be progressive when transfers are measured relative to each country's GDP (second column of Table 8). However, when measured on a per capita basis, any progressivity is far less apparent (final column of Table 8).

[3] To the extent that collections are not proportional to members' GDPs there might be some redistribution here as well. But this would be difficult to measure and almost certainly would be quite small.

[4] The high value of the deflator (a factor of 10) makes this correction mostly redundant. The value of this deflator can be lowered to raise the distributional power of this component.

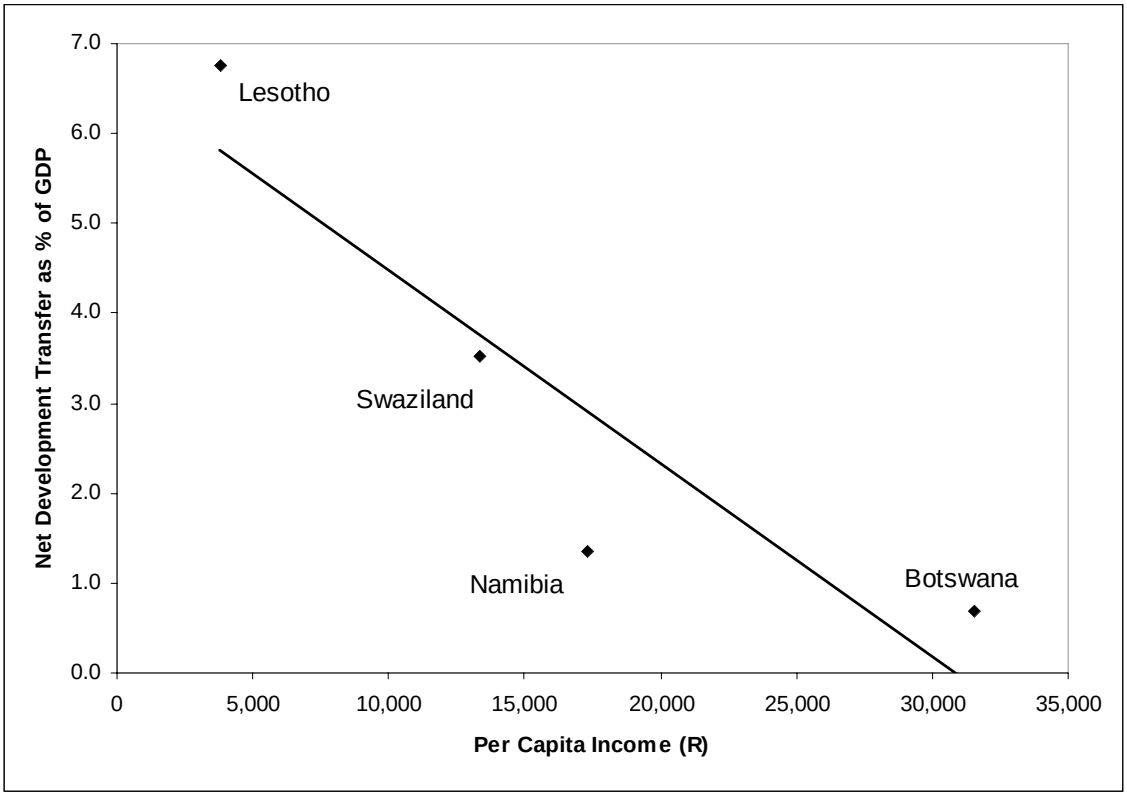
Table 8. Net Development Component Transfers Under SACU RSF, 2006

	Net Transfer (R millions)	Net Transfer (% of GDP)	Net Transfer (R per capita)
Botswana	380	0.7	216
Lesotho	545	6.8	257
Namibia	460	1.4	235
Swaziland	507	3.5	469
South Africa	-1,891	-0.1	-41

Source: Authors' calculations based on official SACU data.

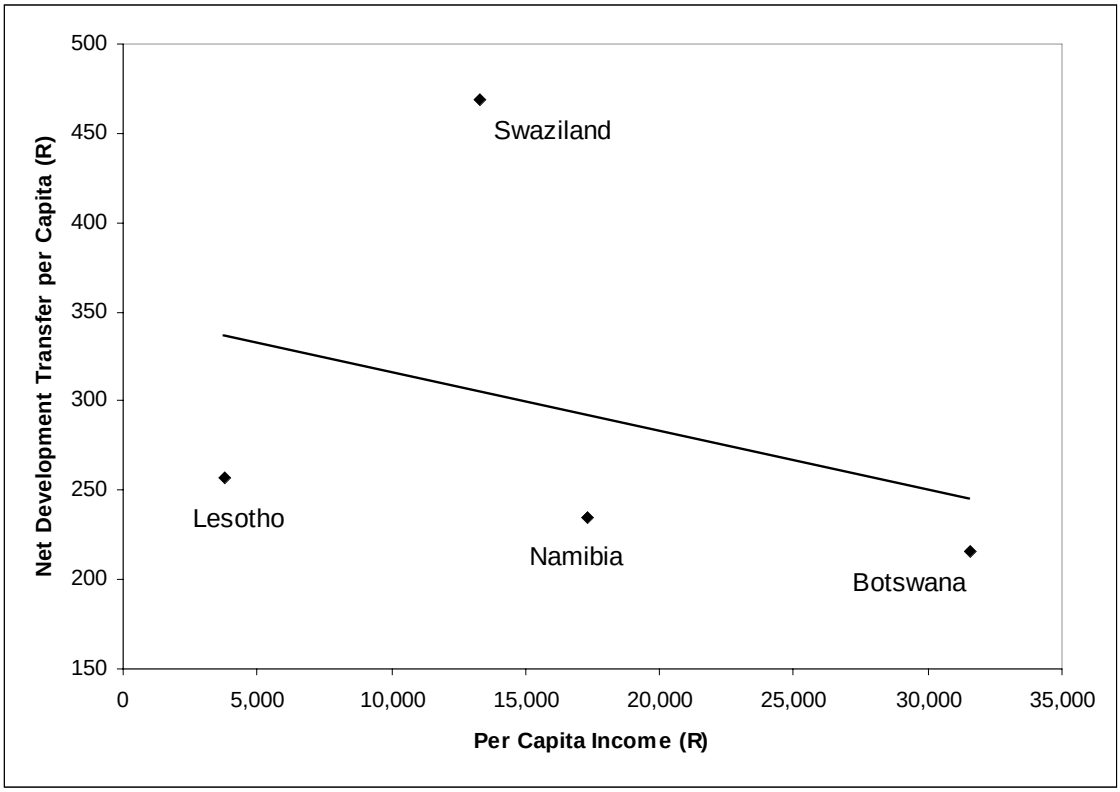
Figures 3 and 4 show plots of development component transfers, first as a percentage of the BLNS GDPs and second on a per capita basis, against their per capita incomes.

Figure 3. Net Redistribution Through the Development Component as % of GDP, 2006



Source: based on authors' calculations.

Figure 4. Net Redistribution per Capita Through the Development Component, 2006



Source: based on authors' calculations.

In both cases the trend lines are negatively sloped, indicating an average structure that is generally progressive, with higher income countries getting smaller transfers, both as a percentage of their incomes and on a per capita basis. The pattern is quite "tight" when looking at transfers as a percentage of income (Figure 3). Relative to the average pattern indicated by the trend line Lesotho and Botswana get relatively higher shares than Swaziland and Namibia.

The relationship between net per capita transfers and per capita income levels (Figure 4) is much looser and it is immediately apparent that Swaziland gets far more than any of the others, and Lesotho, the poorest member, gets a much smaller per capita transfer relative to the overall pattern.

Customs Pool: The largest redistributive transfer under the revenue sharing arrangement at the moment is provided through the customs pool. The net customs transfer should be measured as the difference between the actual customs revenue payments received by each member and their contribution to the SACU pool through tariffs on their own imports from the rest of the world. Unfortunately there is no reliable data on this[5] and so we measure the net transfer received by the BLNS as the difference between their current customs revenue receipts and the revenues they would generate with the SACU tariff applied to their total imports, including from South Africa. This is clearly an overestimate of their contribution to the pool, and so our measure is a serious underestimate of the actual net transfers received by the BLNS and of the net transfers paid by South Africa.

Table 9 shows the size of this estimate of the net customs transfers for each Member State. Unsurprisingly South Africa is a net donor and the BLNS are net beneficiaries. The second column shows the net transfer as a proportion of each member's GDP; this pattern is mildly progressive in the sense that the proportion is inversely related to members' GDPs. As with the development

[5] This is just the flip side of the problem of unreliable data on their intra-SACU imports.

component, however, when the net transfer is measured on a per capita basis, the poorest country, Lesotho, gets by far the smallest transfer.

However, the main purpose of the customs sharing arrangement, at least as historically and currently understood, is not so much to redistribute income from richer to poorer SACU members, but rather to compensate the BLNS for the "cost raising" impact of the SACU tariff. We have already seen that the current formula provides considerable excess compensation in this regard, regardless of how it might be measured.

Table 9. Net Customs Transfers Under SACU RSF, 2006

	Net Transfer (R billions)	Net Transfer (% of GDP)	Net Transfer (R per capita)
Botswana	2.3	4.1	1,294
Lesotho	1.3	16.3	619
Namibia	3.6	10.5	1,823
Swaziland	2.0	14.0	1,860
South Africa	-9.2	-0.7	-199

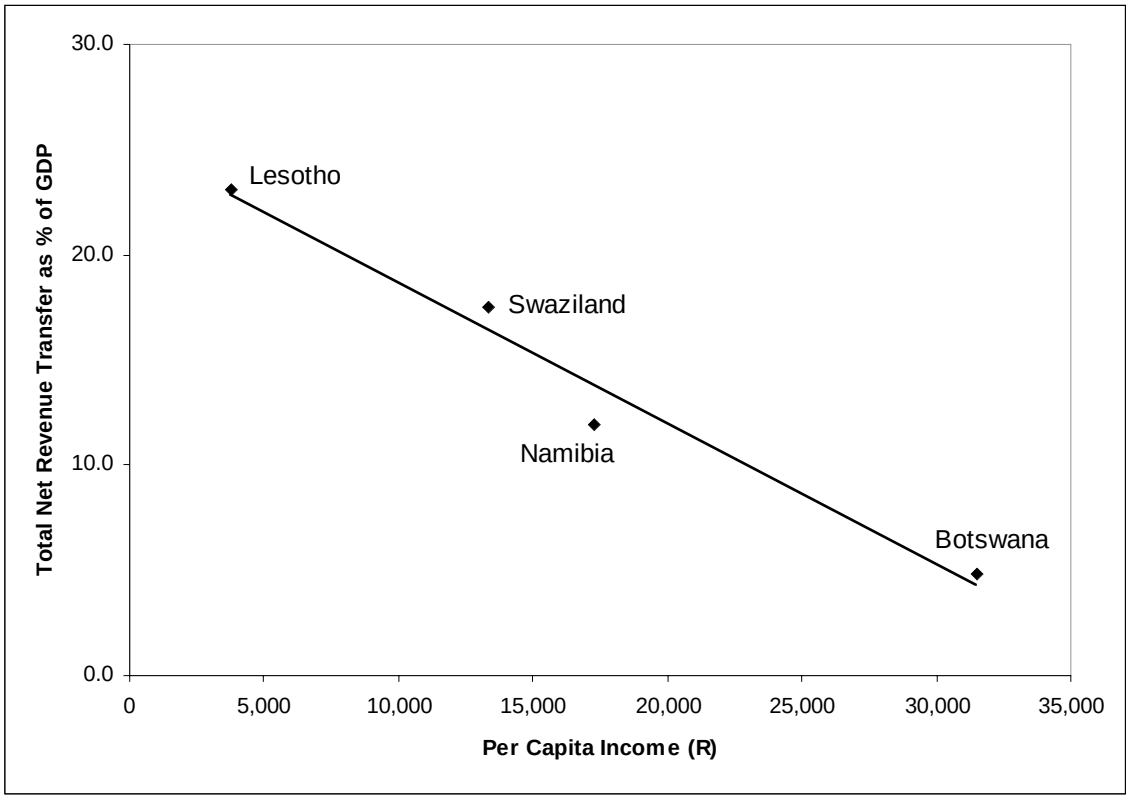
Total Net Fiscal Transfers: Table 10 and Figures 5 and 6 show the combined redistributive effects of the development and customs components of the revenue sharing formula.

Table 10. Total Net Fiscal Transfers Under SACU RSF, 2006

	Net Transfer (R billions)	Net Transfer (% of GDP)	Net Transfer (R per capita)
Botswana	2.7	4.8	1509
Lesotho	1.9	23.1	876
Namibia	4.0	11.9	2058
Swaziland	2.5	17.5	2329
South Africa	-11.1	-0.9	-240

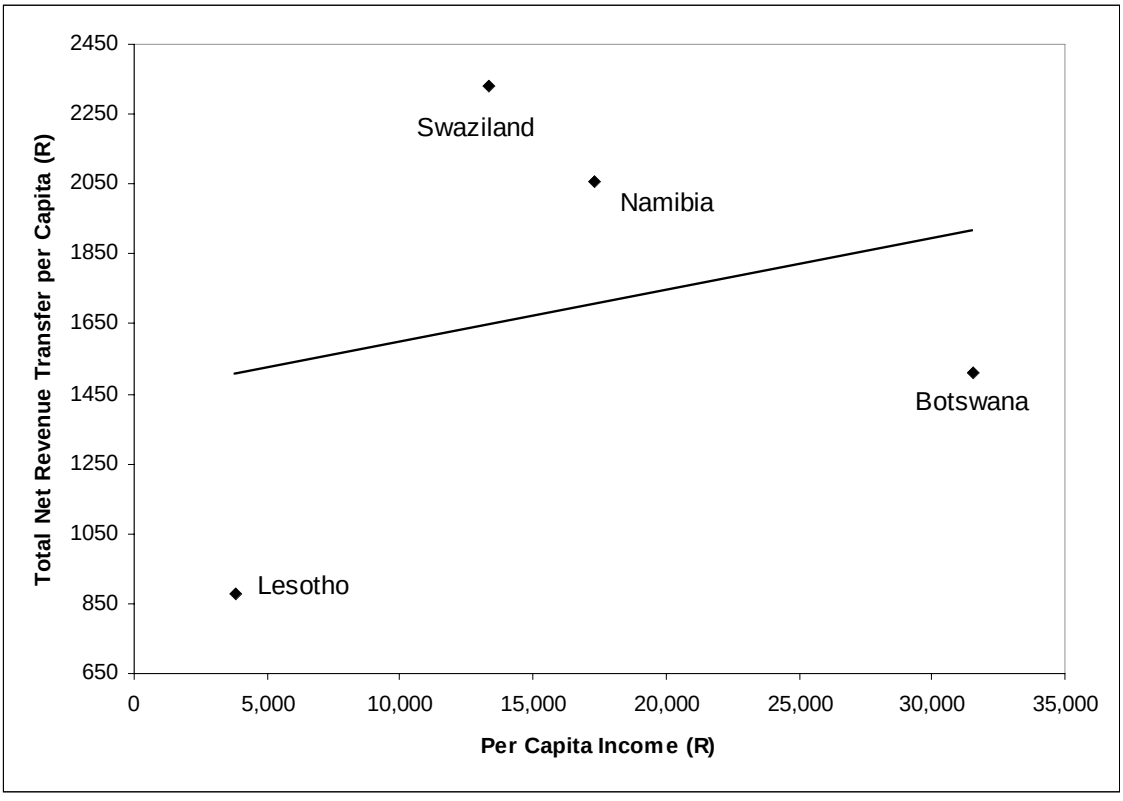
Source: Authors' calculations based on official SACU data.

Figure 5. Total Net Fiscal Redistribution Through the SACU RSF, as % of GDP, 2006



Source: based on authors' calculations.

Figure 6. Total Net per Capita Fiscal Redistribution Through the SACU RSF, 2006



Source: based on authors' calculations.

For the two poorest Member States the net fiscal transfer is obviously very important, accounting for 23 percent of GDP in the case of Lesotho and almost 18 percent in Swaziland. Namibia also gets a large net transfer of 12 percent of GDP and even Botswana, the richest country in SACU, gets a net transfer of almost 5 percent of its GDP. The cost of these transfers to South Africa, the only net donor, is one percent of its GDP.[6]

Figure 5 shows that the total net fiscal transfer is progressive when the transfer is measured as a proportion of members' GDPs. Interestingly enough, this overall pattern appears to be tighter than in the case of the development component, the part of the formula that was explicitly designed to achieve some kind of income-related redistribution. On a per capita basis the overall progressivity is much less apparent. The trend line indicates that, on average, richer countries get larger per capita transfers. The real anomaly in this regard, however, is Lesotho. Although Lesotho gets a net transfer that is a much higher proportion of its income than the other Member States, its per capita income is so much lower than the others that its per capita transfer is still very low relative to what is received by the others. Among the other three countries there is a negative relationship between per capita net fiscal transfers and per capita incomes.

Developmental Impact: In thinking about the possible developmental impacts of the net transfers provided under the RSF it is important to recall that they are *fiscal* transfers—transfers from a pool of tax revenues collected from SACU residents and paid to their respective governments. BLNS citizens contribute through their tax payments into the common revenue pool and their governments are (more than) compensated through receipts from the pool.

What are the immediate and longer-term impacts on the incomes of BLNS residents? At the margin, the net fiscal transfers certainly permit their governments to reduce other taxes and/or increase government spending on some public service(s) and this should be welfare enhancing for the citizens concerned. Similarly, any reductions in RSF transfers in any Member State would almost certainly lead to some combination of increased local taxes and decreased public expenditures.

But are transfers of SACU tax revenues to the governments of poorer Member States the most effective way to enhance the development of these countries? The gross fiscal transfers in Lesotho and Swaziland are already 28 and 24 percent of their respective GDPs (Table 1 above). It is not at all clear that providing even more funds to the public sectors in these countries would the best allocation of resources to further enhance their economic development. Nevertheless, it might still be superficially appealing to compare the per capita transfers received by each of these countries and ask why Lesotho should not receive at least as much as Swaziland. Since their current per capita transfers are R1,398 and R4,256, this would require a tripling of the total gross transfer to Lesotho. This would make its SACU revenue transfer 84% percent of its current GDP. Would such an expansion of Lesotho's public sector necessarily be in its longer-term development interest?

More generally, is it necessarily in the interest of SACU's development goals to tie "development expenditures" to something as arbitrary as overall customs or excise tax collections across the customs union? Unexpected increases in the revenue pool might be a welcome bonus for development expenditures, but might encourage short run spending whose longer-term benefits might be improperly understood. Of greater concern is a short or longer-term decline in some component of the pool. This could be the result of growth accelerating trade policy reforms, for instance, and would not reflect a reduction in the capacity of SACU to engage in useful and complementary development-enhancing investments. To tie development expenditures to arbitrary divisions of and changes in the make-up of the revenue pool is not necessarily consistent with SACU's longer-term development goals.

[6] Recall that because of the lack of reliable data on BLNS imports from the rest of the world, these are an underestimate of the benefits of the net fiscal transfers to the BLNS and of their cost to South Africa.

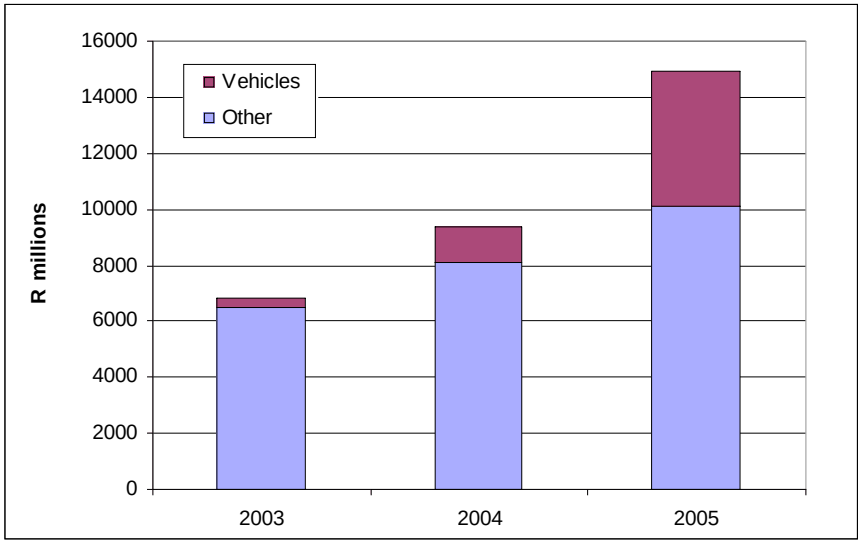
In summary, the RSF provides a large and generally progressive pattern of redistributive fiscal transfers among the BLNS. Their large size and the fact that they operate solely through increases in the size of the public sectors of the poorer members has some questionable implications for their long term developmental impact. Thought should be given to the design of more broad reaching and effective development policies and mechanisms in SACU. Untying this development effort from the revenue pool would make this much easier.

4.4 The Future of the Customs Pool

An immediate source of concern to South Africa arising from the implementation of the new revenue sharing formula has been the rapid and unexpected rise in payments to the BLNS. The total payment to the BLNS has risen from R9.7 billion in 2003/04 to a projected 19.7 billion 2006/2007. As a percentage of total South Africa consolidated expenditure it has increased from 2.8 to 4.0 percent over this period. This 'shock' has little or nothing to do with the manipulation or exaggeration of intra-SACU trade data. The share of intra-SACU trade reported by the BLNS has fallen marginally since the final revenue sharing negotiations and South Africa has recorded the third highest import growth rate. It is almost entirely a function of the dramatic increase in customs duties collected by South Africa over the last few years.

To understand the size of the current payment and its future trajectory it is therefore essential to explain this boom in customs duties. There appear to be two main causes. First, import volumes have risen in response to a stronger rand and buoyant consumption expenditure. But in 2005, the total value of imports increased by 15 percent, while the duties collected on these imports rose by 60 percent! The second and more important cause has been the sharp rise in duties paid on automobile imports. Until recently, exports of vehicles grew much more quickly than imports and a large and increasing proportion of duties payable on the importation of vehicles was offset by IRCCs (Import Rebate Credit Certificates) earned on exports. But that has now changed and imports of vehicles are now growing much more quickly than exports. As a result, there are relatively fewer IRCC's to go around and much more duties to be paid. The net contribution of duties on vehicles to the overall customs pool is shown in Figure 7 below.

Figure 7. Breakdown of the SACU Customs Pool



Source: SARS Customs revenue data.

The customs pool and SACU payments are therefore highly sensitive to changes in imports and tariffs, and in the case of the motor industry, to changes in exports and the MIDP too. In just two years between 2003 and 2005 the contribution of duties on motor vehicle imports has risen from 5 to 32 percent of total duties collected. The tariff rate on motor vehicles is high (34 percent in 2005) and imports robust. Future reductions in tariffs will reduce the marginal contribution of vehicle imports to the pool, but might contribute to even more rapid import growth. The net impact on the SACU payment will, in the short-term, depend on the relative strength of these countervailing effects. But in the longer run, with continuing trade negotiations at the multilateral and regional levels, there can be little doubt that customs revenue will be of declining importance as a revenue source for SACU.

To demonstrate the likely outcome of different trade and tariff environments, we have estimated the impact of three possible scenarios on the customs and excise receipts of the BLNS under the existing revenue sharing formula from now until 2020. These scenarios are:

- ***Scenario A: Structural Adjustment***: SACU implements an aggressive round of multilateral tariff reforms (in line with current commitments under the EU TDCA), beginning in 2008, and concluding in 2020. But the import volume response is muted (2.5 percent per year). This is probably the worst case for the BLNS.
- ***Scenario B: The Middle Road***: SACU agrees to a modest phase-down in tariffs from 2008 to 2020 (in line with the Swiss Formula 25 currently under discussion at the WTO). The import volume response is equally modest (5 percent per year). This is probably the most realistic long-run scenario.
- ***Scenario C: More of the Same***: Tariffs remain at current levels throughout the forecast period and import volumes continue to grow at a robust pace (7.5 percent per year). This is the probably the worst case for South Africa.

A number of additional assumptions have been made and remain consistent in all three scenarios:

- The Customs collection rate remains constant at 80 percent of the maximum amount of duties collectable;
- 40 percent of imports are sourced from the EU (and taxed accordingly) and 2 percent of imports are sourced duty-free from SADC;
- Specific excise duties grow at a nominal rate of 8 percent throughout the forecast period;
- *Ad valorem* excise duties grow at the same rate as imports;
- World price inflation remains constant at 2.5 percent;
- The nominal effective rand exchange rate depreciates, on average, by 2 percent per year;
- The relative size of each SACU member country's GDP, GDP/capita and intra-SACU imports remains unchanged throughout the forecast period.

The impact of these different scenarios on total customs and excise collections is shown in Figure 8 to 10 below. In Scenarios A and B, the impact of tariff reform on the relative size of the customs pool is clear. The BLNS would have good reason to resist any reduction in the common external tariff. On the other hand, if tariffs remain unchanged and imports continue to grow apace (Scenario C), the customs pool will accelerate over the forecast period and most of this gain will go to the BLNS.

Figure 8. Scenario A

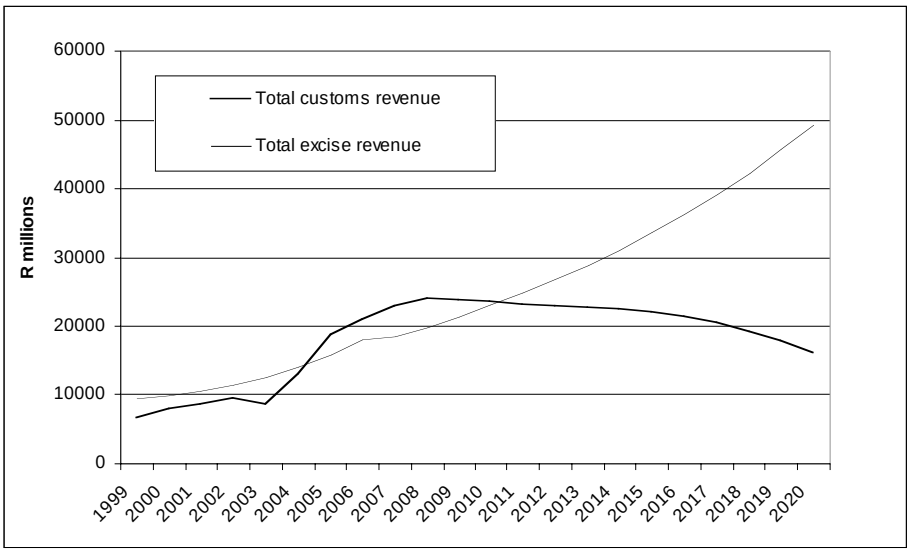


Figure 9. Scenario B

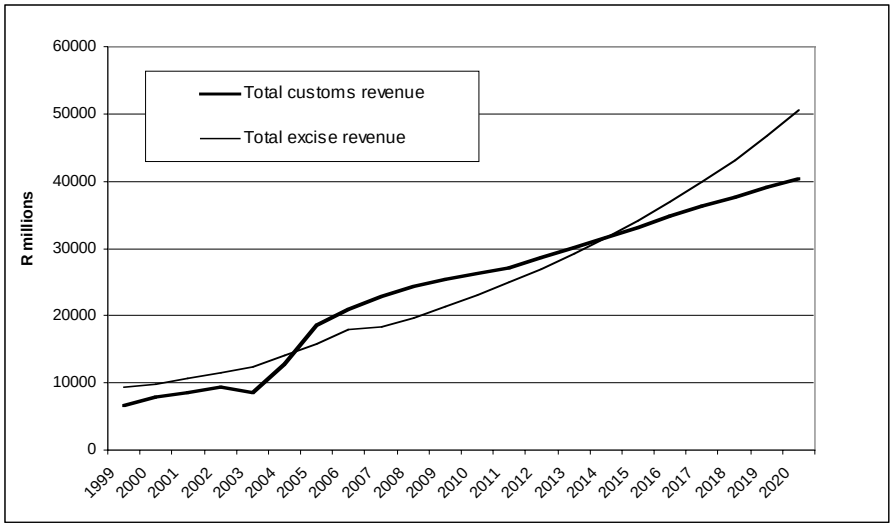


Figure 10. Scenario C

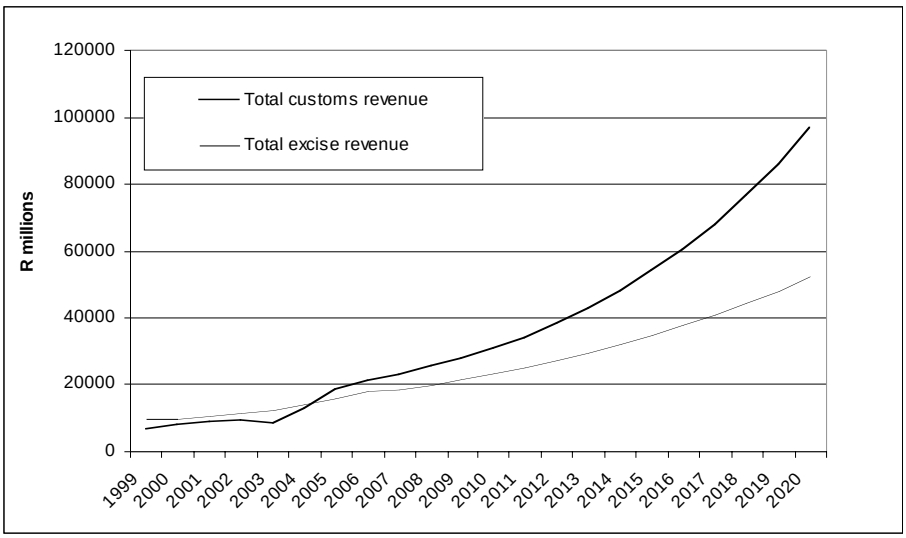


Figure 11 shows the change in the absolute size and the distribution of the SACU payment under the three long-run scenarios. The difference between the nominal value of the total SACU pool under the three different scenarios should serve as another stark warning to the BLNS, all of which depend on SACU payments for a significant portion of their total budget revenue. In 15 years this pool could remain relatively stagnant (a large decline in real terms) or it could multiply by a factor of 4 (almost doubling in real terms). Although the contribution of the excise and development component is expected to rise, the BLNS will remain particularly vulnerable to fluctuations in customs duties.

Figure 11. Size of Revenue Pool Components Under Different Scenarios

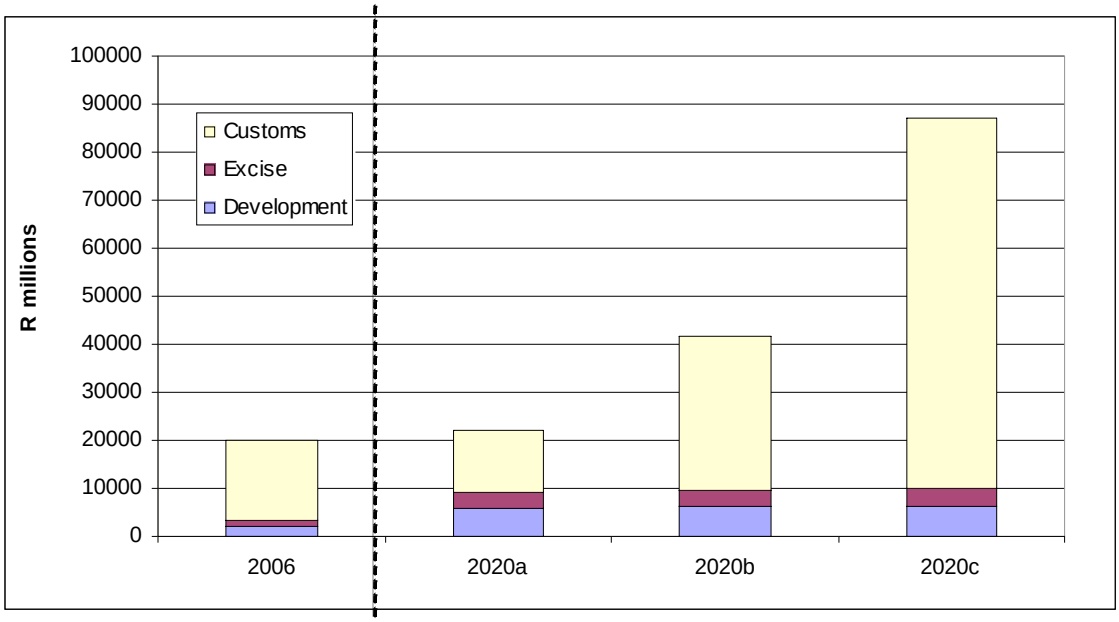


Table 11 shows some estimates of the change in the share of SACU revenues in Members' GDPs as a result of Scenarios A, B and C. With no tariff reform, BLNS receipts under SACU will rise considerably as a share of GDP. Trade liberalisation of any intensity is likely to see SACU revenues fall relative to GDP, though this decline will be tempered somewhat among the poorer countries by the increasing importance of the development component.

Table 11: Members' SACU Revenues, 1994-2020

	SACU Revenues as Share of GDP (%)					
	1994	2002	2006	2020a	2020b	2020c
Botswana	8.0	4.6	8.6	2.4	4.6	9.4
Lesotho	28.0	18.1	32.3	14.5	25.9	52.2
Namibia	7.7	7.3	14.7	5.4	10.6	22.5
Swaziland	13.7	11.2	23.5	9.3	17.6	36.6
South Africa	1.6	1.1	1.1	1.0	1.1	1.4

4.5 Tax Harmonization

Outside of customs duties and excises there has been very little attention to tax harmonization in SACU. This is an area in which progress could be made without too much technical difficulty and where the gains to all members could be substantial.

Income Taxes and Tax Incentives: Through SIP and other experiments, South Africa has learned at first hand about the high costs and the perverse economic outcomes that result from the use of company tax incentives. Nevertheless, increased use of such incentives in neighbouring countries makes it difficult to resist pressures to repeat these mistakes. In the BLNS countries, the huge levels of fiscal support provided through the RSF make it much easier to acquiesce to the continued erosion of the income tax base through the use of incentives. There are obvious mutual gains to agreement on disciplines in the use of tax incentives.

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

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

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

5 The Way Forward: Policy Choices and Strategic Considerations

Implementation of the new SACU revenue sharing formula has revealed two related problems. The first relates to the formula itself and the second to the perverse incentives it creates for future SACU trade policy.

There has been a tendency to view the problem as primarily a technical one about reliability of intra-SACU trade data. Current data on intra-SACU trade provided by the BLNS and South Africa is extremely inaccurate, and from an economic perspective, it provides no real basis for the distribution of customs duties. Unfortunately, the major entrepôt role played by South Africa in the trade of the BLNS would make it just as difficult to implement a formula based, more traditionally, on members' imports from the rest of the world (i.e. outside of SACU).

The bigger problem is that the RSF has been designed to accomplish several different goals and it simply might not be nimble enough to engage in such multi-tasking.

The RSF currently serves three main purposes:

- It is a tax collection and coordination mechanism for collecting common excises and customs revenues on behalf of the five Member States.
- It has been regarded as a means for compensating the BLNS for the cost raising effects of the SACU (*aka* South African) tariff.
- It is a means for distributing fiscal revenues from wealthier to poorer members, to promote economic development of the poorer members and to prevent polarization within SACU.

Reviewing these in reverse order we have reached the following conclusions.

- The development component of the RSF provides a progressive pattern of fiscal redistribution among the BLNS, with RSA as the only contributor.
- The redistribution of the customs pool provides far more compensation than necessary for the "cost raising effect" of the SACU tariff, with the result that it also provides a very large net fiscal transfer to the BLNS.
- The dependence of the BLNS on South Africa's collection of excises and customs duties provides them with a large and perverse incentive to resist any attempts to rationalize these taxes.

It is difficult to believe that the long-term development interests of the BLNS are served by a system that bloats their public sectors,[7] blunts their inclination to develop sustainable revenue systems and encourages them to resist trade reforms that would assist and promote their integration in the global economy.

While BLNS governments have benefited from this system recently, they must soon realize that it is dangerous to rest long-term development cooperation strategies on the fickleness of changes in the SACU customs revenue pool.

All of these considerations provide cause for all parties to give serious thought to alternative revenue sharing strategies.

Furthermore, in the event of SACU expansion it is unlikely that the current members (South Africa and the BLNS) would be willing to confer similar benefits on poor new members. The current RSF reflects historical legacies that would not apply to other new members. For this reason as well it might be useful to think of ways of treating some of the current functions of the RSF separately, through some different mechanisms. This would permit such arrangements to continue undisturbed in the face of SACU expansion.

The best strategy would be to separate the revenue collecting and development functions of the revenue pool. This would untie the development budget from arbitrary trends and fluctuations in customs revenues (and excises) and eliminate perverse incentives regarding the development of trade policy. And it would permit the design of development strategies that were not wholly dependent on inflating the size of the government budgets in the BLNS.

[7] The public sectors of the BLNS are about 90 to 100 percent larger on average than for the rest of sub Saharan Africa (excluding RSA and Nigeria). (Source: Sub Saharan average from Table 7.6, World Bank *African Development Indicators 2004*.)

One way to do this would be to a) remove most of the redistributive effect of the current customs sharing arrangement by basing the shares of all members' on imports from everywhere, i.e. of intra-SACU and extra-SACU imports and b) develop a separate development budget that would draw on the common revenue pool but not necessarily be tied to it in any rigid proportions[8]. This would remove most of the perverse trade policy incentives created by the current customs sharing arrangement. And it would allow the new development fund to be designed and operated against sensible development criteria and not depend solely on increasing the size of BLNS government budgets.

An alternative would be to continue with something closer to the current arrangement but on condition that the BLNS agree to defer all tariff-making decisions to RSA. This is the only way to justify the excessive compensation provided to the BLNS and to eradicate the perverse tariff incentives under the current RSF. Such an agreement would need to recognise the long-term decline in the importance of customs revenues and might include some commitment from RSA to increase the size of the development component (or create a new development fund as discussed in the previous paragraph) with tariff reform. This arrangement might also be accompanied by an agreement to fix customs shares at some recent average levels. This would avoid needless ongoing disputes over trade data that, as we have seen, have had almost no impact on revenue outcomes for anyone.

The first of these solutions would provide the basis for a larger and more sustainable regional integration arrangement in Southern Africa, but it might be regarded as too politically difficult or costly. The second-best solution should be easier to achieve, especially if all SACU member countries accept that the current scale of transfers are excessive and unlikely to continue. There are strong potential benefits to all parties in working out a new arrangement that enables SACU to expand and integrate with the global economy while preserving some kind of development assistance in the longer run.

The real challenge might be to seek a middle road between the easy and the more difficult options outlined here. Any worthwhile solution would certainly have to remove the perverse trade policy incentives that cloud the future of the current arrangement. It should include a range of other measures to make SACU work better in achieving its primary purpose as a customs union to facilitate trade among its members and with the rest of the world. Among these should be included coordination of border posts, VAT and other tax harmonization, and disciplines on arbitrary trade restrictions.

[8] It would be even better (in the sense of removing any unintended redistributive effects) to base shares of customs revenues on extra-SACU imports; but this would face the same problems as are currently faced in measuring intra-SACU imports.