Evaluation of an Appropriate Model for a SADC Customs Union – Policy Brief

FINAL

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The full report can be downloaded from:

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OPTIONS AND CHOICES

Having decided that SADC should move to a Customs Union (CU) by 2010 the task now facing the region is to identify the options and select modalities. The essential feature of a Customs Union, differentiating it from other forms of regional integration (which may operate in parallel), is its treatment of tariff and non-tariff barriers to trade in goods and the distribution of revenue collected on these goods. The main report reviews the international experience of other customs unions, describes a number of approaches to regional trade and tariff policy, and assesses the potential ***economic*** impact of these different 'models' on SADC.

There is no single 'model' to guide SADC; international experience is very mixed. But all the schemes reviewed face the same fundamental issue which is that a Customs Union is not a political union yet it necessarily cedes some of the sovereign powers of its members to an inter-governmental (or supra-national) body. Membership requires countries to give up some independent decision making powers (for as long as they remain a member of the Union).

This creates tensions which is why the international experience of CUs is characterised by lengthy transition periods, slow movement towards the 'ultimate goal', and occasional reverses. But members persevere both because the CU can enhance economic growth, primarily by increasing and enhancing members' integration both with each other and with the global economy, and for political reasons (for example to foster broader unity or to establish a stronger international negotiating position).

The full range of options (and their implications) can be understood only by reading the full Report. In this 'Policy Brief', we identify the key modalities that will need to be agreed in the near future if the 2010 deadline is to be met. Essentially, these choices and the scale of the economic gains likely to arise from the SADC CU revolve around: the level and complexity of the CET; the method for sharing and distributing revenues; and the additional contribution of a CU to trade facilitation. The possible options and economic impact of these decisions are discussed briefly below.

1. Options for a common external tariff

An essential feature of a CU is that by the end of the implementation period all countries levy identical tariffs on their imports. This enables them to abolish many key internal customs controls and thus unlocks the gains that can be achieved by freer international trade, internally and with the rest of the world. The longer the transition period the longer it will be necessary to wait before removing customs barriers made necessary by different trade policy regimes.

International experience suggests that the implementation of a common external tariff (CET) will be a complex and lengthy process, not least for SADC given that countries' initial trade policies are very different as are their trade patterns and industrial structures. However, it is not necessary for SADC to have implemented the ultimate CET for every single product by 2010 (still less to have applied all the agreed tariffs). What is important at this stage is for members to agree on a common 'concept' of the broad level and complexion of the tariff. This is because it is the 'concept' of the CET that will determine the necessary modalities, instruments and institutions for revenue sharing and adjustment.

The ultimate CET is unlikely to be identical to the existing tariffs of any one member, but it will be closer to some than to others. The report models the effect on the economies of SADC states and their revenue of various illustrative tariff options. It also models for comparison purposes the impact of not creating a CU but simply completing the FTA and retaining separate national trade policies. There would appear to be two main tariff options:

- Negotiating a complex CET, presumably based on something like the existing SACU tariff; or
- Agreeing to a much simpler, more uniform tariff structure.

Option	CET	Economic Evaluation
A	**Complex (SACU)**	Setting the CET at a level and complexity comparable to the current SACU regime would produce the smallest economic gains for the region, substantial trade diversion, significant revenue losses for most members and few offsetting gains for consumers and users of imported goods. The economic gains of this option are little more than will be achieved from simply completing the FTA and most of these benefits accrue to South Africa. This is because most other SADC member states export primarily to countries outside of SADC, whilst a large part of South Africa's exports are destined to the region. Giving South African exporters a substantial tariff advantage over alternative suppliers, would result in costly trade diversion for other countries. The adoption of a complex or high tariff structure would not be in the best interests of the region.
B	**Simple**	A simple tariff option produces greater economic gains than the first option. The scale of the gains will depend on the level of the tariff; the lower the average tariff the lower the scope for trade diversion and the greater the potential for economic integration among members and with the rest of the world. The overall gains, however, would come at the cost of revenue losses for many member governments, reflecting a transfer of tariff revenues from governments to consumers and users of imported goods. The report suggests that an average and flat tariff somewhere between 5% and 10% would produce the best balance of regional economic growth, revenue and equity between members. Still, fiscal transfers and technical support might be required to assist some of the poorest member states in rebalancing tax revenue sources.

2. Options for collecting and distributing revenues

Whatever the CET adopted, members will have to decide on how tariff revenue is to be collected and, depending on this (and the level of tariff), how it is to be shared. Most CUs adopt the 'destination principle': tariff revenue accrues to the country where the import is finally consumed. This has significant attractions since it means that CU members retain control over the revenue they collect and the need for a revenue sharing arrangement disappears. But in the context of SADC it also poses serious problems. The alternative to the destination principle is that revenue is collected at the point where it first enters into the CU – and is then distributed between members according to a pre-determined regime. This requires, therefore, additional agreements on:

- the basis on which the revenue will be shared; and
- whether or not some form of compensation mechanism is needed.

Option	Collection	Distribution	Economic Evaluation
1	**At destination**	**At destination**	Customs processing and collection of import duties at final destination would require forgoing almost all the benefits of forming a common customs area and moving to a customs union. It would require strict, costly and virtually impossible to administer bond processes and possibly even rules of origin to distinguish between goods that had originated elsewhere and from within the customs union. Furthermore, unless members are willing to forego the valuable entrepôt services performed by the more developed member states, a large share of the revenues that "ought" to accrue to other members under a destination principle would actually be collected and retained by these countries. Thus, under this system, either a disproportionate share of revenue would accrue to the dominant trading countries, particularly South Africa, or very costly administrative procedures would need to be put into place. Both would significantly negate the advantages of moving to a Customs Union.
2	**At entry**	**Formula**	An approach where imports are processed and duties collected from the rest of the world at the point of first entry into the CU would greatly diminish the administrative and compliance costs associated with the destination principle and would enable much freer movement of domestically produced and imported goods between member states. This would only work if all members of the CU trusted the capabilities and integrity of each other's customs services. Furthermore, collecting tariffs at the point of first entry into the union would mean significant revenue gains for countries that serve an important entrepôt and/or manufacturing role in the union, especially South Africa, and reductions in government revenue in countries that ultimately use or consume goods imported through these other members. This *necessarily* requires an arrangement to re-distribute revenue from countries through which a disproportionate share (relative to their own consumption) of goods enter the CU to those (often landlocked) ones where some of the imports are consumed. The formula to achieve this redistribution should be designed to replicate, at least roughly, what would be achieved according to the use of the destination principle.
3	**At entry**	**Formula + Development Fund**	In addition to a revenue sharing formula, mechanisms to achieve community development goals are likely to be necessary. This would require new institutional structures to facilitate cooperation and might involve the establishment of a fund to which all members would contribute and would also be eligible to receive grants for development projects. Contributions to this Development Fund should be related to the size and level of development of individual member states and should be independent from customs collections. The major objectives of the Fund might include, among other things, supporting cross-border projects, promoting mutual development and assisting lagging regions.

3. The importance of trade facilitation

Trade facilitation is a major problem in SADC, and attempts to improve it have been a major focus of SADC activity. Some of the problems arise from the nature of the FTA itself, and/or from its manner of implementation. With each country operating its own customs area and with minimal coordination between them; with substantial differences in external tariff structures and resulting concerns about leakages of goods from low tariff or poor-quality enforcement regimes to countries with higher tariffs of better customs services; and with complex rules of origin made necessary by large tariff structure differences, border management is difficult and costly. This detracts from the basic goal of intra-SADC trade liberalization and enhanced regional economic integration.

Possibly the most demanding part of creating a CU will be the on-going and substantial administrative changes that are needed to improve trade facilitation and deepen regional integration. This would be enhanced substantially by the eradication of rules of origin that would no longer be necessary in a common SADC customs area. But in addition, the development of a concerted programme of action to simplify and harmonise border rules and procedures across the region would need to be a key priority. Without such changes, many of the economic gains from the CU will not materialise. Other than the elimination of rules of origin, none of these actions are pre-conditions to the establishment of the CU, and ongoing progress in this area does not depend upon the formation of a CU in 2010.

THE NECESSARY INITIAL STEPS

International experience shows that SADC would be unique if, by 2010 or any date close to this, it were to implement all aspects of a CU. The universal approach elsewhere is that a CU is 'launched' at a particular time with certain key decisions taken but others waiting for further discussion and implementation. What would SADC need to have agreed to allow such a 'launch' to take place?

The key decisions that need to be taken are those that establish:

- the 'ultimate destination' – the trade policy regime that members hope eventually to achieve so that countries can decide whether or not it meets their development objectives; and
- the features of the administrative, financial and decision making institutions that would be required by a CU with this agreed complexion and will be introduced during the implementation period.

The analysis presented in the main report and summarised above suggests that the main economic gains from forming a SADC Customs Union will be derived from increasing and enhancing members' economies with each other and with the global economy. This requires that SADC commit to a **moderate and simple common external tariff**. It also suggests that **customs duties should be collected on entry** into the customs union and should then be distributed according to a simple revenue sharing formula that best mirrors the final destination of the goods on which these duties are collected. An agreed proportion of duties collected should be retained by collecting authorities to cover administration costs and encourage compliance.

The implementation of this 'model' would require the establishment of various new institutions:

- **Common trade institutions** for setting tariffs, implementing anti-dumping and other kinds of contingent protection measures, and participating in external negotiations.
- **Communal development mechanisms**. This is likely to include the creation of a fund to support regional projects and promote economic development across the union and in particular countries. The actual structure, size and operation of the proposed development fund would need to be negotiated. A key initial adjustment project would be to provide assistance, especially for poorer members, to engage in necessary fiscal reforms and ultimately to design schemes for increased indirect tax harmonization, at least among geographically contiguous members of the customs union.

Membership of a SADC CU need not be limited to countries that are ready to implement these features by 2010. But there are core actions that must have been taken before a country can move beyond candidate membership of such a CU. The independent decisions of SADC states on these core decisions will effectively determine membership. They are:

- join the single customs territory (which necessarily requires leaving any other multi-country customs territory);
- implement fully the SADC Trade Protocol;
- accept from the date of membership the agreed CET for most imports; and
- transfer customs revenue collected on goods entering the CU via their national territory.