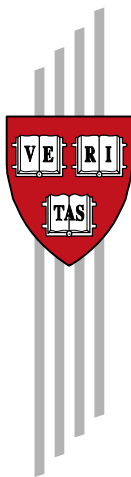


# **SACU Tariff Policies: Where Should They Go From Here?**

Lawrence Edwards and Robert Lawrence

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## SACU Tariff Policies: Where Should They Go From Here?

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**Abstract:** This paper characterizes the current South African Customs Union (SACU) tariff structure, considers its rationale, proposes and evaluates some alternatives for reform. While considerable progress was made earlier in liberalizing and simplifying SACU's tariff structure, over the past few years such movement appears to have halted. This is unfortunate because trade performance is a key constraint in attaining South Africa's growth objectives. The tariff structure remains excessively complex and opaque and biased against exports. The differentiation provided to different sectors appears mainly to be the result of historical accident and is not justifiable as efficient job preservation, equitable income distribution or on infant industry grounds.

Some still continue to defend the complex structure as necessary to provide producers of particular products with precisely the amount of protection they need to become competitive. But their arguments are unconvincing. There may be a case for exceptional temporary safeguards and infant industry protection but a broad complex structure is likely to allocate resources inefficiently: channelling them away from activities in which South Africa is competitive and towards those in which it is less efficient. Protection of inputs is particularly damaging and distorting of the choices of those seeking to benefit and export. In addition, the government simply does not have the requisite information (or instruments) to apply such differentiation appropriately to such a large number of products. Inevitably, therefore the structure encourages and reflects rent seeking.

Using simple tariff structures that have a zero and just one or two tariff bands we show that it is possible simultaneously to provide benefits to consumers, limit employment dislocation by conferring a reasonable degree of effective protection on finished goods, reduce export taxes, improve transparency and provide a norm against which industrial policy priorities can be set. The long run goal would be a globally competitive SACU region that provides producers with access to inputs at world prices.

South Africa's regional trade policies require attention. The African continent plays a key strategic role in South Africa's export diversification strategy and regional development is a vital priority. The current SACU tariff sharing formula is expensive and defective. A major reform of SACU tariffs would make particular sense for the BLNS countries, allowing these nations access to cheaper inputs and final products. It would also provide the opportunity to renegotiate the SACU revenue-sharing formula, more clearly and rationally separating its aid and tariff-revenue sharing components. SACU should avoid unrealistic commitments to customs unions with other African partners. In its other regional arrangements (e.g. with SADC) SACU should place primary reliance on free trade agreements and other projects (e.g. infrastructure) that enhance integration.

**Keywords:** trade policy, regional integration, South Africa, trade simulations

**JEL Codes:** F13, F15, F17

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## **SACU Tariff Policies: Where should they go from here?**

**By**

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## ABSTRACT

This paper characterizes the current SACU tariff structure, considers its rationale, proposes and evaluates some alternatives for reform. While considerable progress was made earlier in liberalizing and simplifying SACU's tariff structure, over the past few years such movement appears to have halted. This is unfortunate because trade performance is a key constraint in attaining South Africa's growth objectives. The tariff structure remains excessively complex and opaque and biased against exports. The differentiation provided to different sectors appears mainly to be the result of historical accident and is not justifiable as efficient job preservation, equitable income distribution or on infant industry grounds.

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### **SACU Tariff Policies: Where should they go from here?**

The tariff structure that South Africa (and SACU) inherited from the apartheid era was defective on at least five counts. First, reflecting the import – substitution orientation of the government, it was extremely protectionist. This had the effect not only of discouraging imports but also of taxing exports by raising production costs. Second, the structure was both complex and opaque. There were over 200 different rates, and tariffs took a number of forms: *ad valorem*, specific, mixed, compound, and formula duties based on reference prices. This made it very difficult to estimate how much protection was actually being granted. As a result, a World Bank Study (Belli *et al.*, 1993) concluded that by the end of the 1980s compared to a range of developing countries, South Africa had the highest number of tariff rates, the widest range of tariffs and the second highest level of tariff dispersion. Third, SACU decision-making processes were unrepresentative. South Africa unilaterally determined tariffs, while other SACU members were forced to simply fall in line. Fourth, the arrangements for sharing tariff revenues while relatively generous to other SACU members were problematic because they committed South Africa to pay amounts that did not reflect the actual tariff revenue generated and in fact payments could have eventually turned out to be greater than the tariff revenues actually received. And finally, since apartheid South Africa, as a pariah state, was not a feasible partner, the arrangement presented structural problems for SACU in its relationships with other trading partners.

Some progress has been made in ameliorating all of these problems. (a) As summarized in Table 1, the SACU trade regime has undergone considerable liberalization. Between 1990 and 2006, the average applied rate was reduced from 27.5 to 8.2 percent. Although the GEIS subsidy for exporters was eliminated, the anti-export bias of the tariff structure was considerably reduced because of tariff reductions on inputs. (b) The tariff structure has also been simplified. The number of different MFN bands was 209 as recently as 2000, but it has been cut in half - to 100 in

2006. The proportion of duty free MFN tariff lines is up from 44.6 percent to 52.9 percent and non ad-valorem tariffs which were 25.6 percent of all MFN tariffs now comprise just 2.9 percent of all MFN tariffs. (c) In 2002, in a new SACU Agreement, commitments were made for increasing the participation of the BLNS (Botswana, Lesotho, Namibia and Swaziland) in SACU decision-making, (d) At the same time, the 2002 Agreement implemented a new revenue sharing formula (RSF) that prevented South Africa from having to pay out more than its tariff revenues; and finally (e) a number of regional initiatives have been negotiated and implemented, most notably South Africa's accession to the SADC trade protocol and its Trade, Development and Cooperation Agreement (TDCA) with the European Union.

**Table 1: Structure of MFN tariffs of SACU, 1990-06**

	1990	1997	MFN	MFN	MFN	2006			
			2000	2001	2002	MFN	EU	SADC	Total
1. Number of tariff lines	> 13000		7824		7888	6420	6420	6420	
2. Number of different rates (bands)	200		209		150	100	95	9	150
3. Bound tariff lines (% of all tariff lines) <sup>a</sup>		96.4	96.4	96.4	96.2	96.6			
4. Duty-free tariff lines (% of all tariff lines)		42.4	44.6	44.5	43.6	52.9	65.9	99.4	72.7
5. Non-ad valorem tariffs (% of all tariff lines)		25.6	24.8	24.6	2.9	2.9	2.3	0.1	1.8
6. Tariff quotas (% of all tariff lines)		8.1	7.4	7.2	7.3	..	..	..	
7. Simple average applied rate	27.5	15	12.8	12	11	8.2	4.8	0.1	
8. Import weighted average					6.6	7.4	7.9	0.1	7.3
9. Maximum rate	1389		187		78	108	108	60	108
10. Minimum rate	0		0		0	0	0	0	
11. Agricultural products (HS01-24)		11.4	11.3	11.4	11.5	9.4	5.5	0.0	
12. Non-agricultural products (HS25-97)		15.4	12.9	12	11.4	8.0	4.7	0.1	
13. Domestic tariff "spikes" (% of all tariff lines) <sup>b</sup>		4	5.8	4.5	4.5	8.8	14	0.4	
14. International tariff "spikes" (% of all tariff lines) <sup>c</sup>		39.4	34.4	34.1	34.9	21	8.8	0.2	10
15. Overall standard deviation of applied rates		17.8	15.1	13.9	12.6	11.1	7.9	1.6	0
16. "Nuisance" applied rates (% of all tariff lines) <sup>d</sup>		0.2	0	0	1.4	1.3	0.8	0	0.7

.. Not available.

n.a. Not applicable.

a Refers to Botswana, Namibia, South Africa, and Swaziland. Lesotho bound 100% of its tariff.

b Domestic tariff spikes are defined as those exceeding three times the overall simple average applied rate (indicator 8.).

c International tariff peaks are defined as those exceeding 15%.

d Nuisance rates are those greater than zero, but less than or equal to 2%.

Note: Indicators 3 and 6 are calculated taking into account all tariff lines (i.e. in-quota and out-of-quota lines).

Source: Source: WTO Trade policy report (2003) and own calculations.

Nonetheless, as we will elaborate further, the tariff structure, the revenue sharing formula and South African regional trading arrangements all have scope for improvement.<sup>1</sup> In the first section of this paper, we discuss some desirable characteristics of tariff structures and then characterize the current tariff structure in detail; in particular we provide measures of the nature of current protection, the degree to which exports are taxed and point to its complexity and opaque nature. In the second section we consider possible justifications for the current structure such as the impact on employment, income distribution and infant industry protection. We find that none are convincing. Current tariffs are inefficient in general and particularly inefficient with the respect to their costs in supporting employment. They are regressive in their impact on income distribution and preservationist rather than strategic in their orientation. We also consider and reject the argument that a highly differentiated structure is really necessary to provide producers of each individual product with precisely the protection they need. In our view a case-by-case approach which sets individual tariffs differentially is more likely to be counterproductive, misallocate scarce resources in the economy and reduce South African living standards by giving the most protection to the activities in which South Africa is the least efficient economically and the most organized politically.

In the third section we show how the structure could be improved through a far simpler approach. Our tariff reform proposal is to simplify the tariff structure through the elimination of tariffs on intermediate and capital goods and the reduction of tariffs on final goods by fairly large percentages. This strategy relies heavily on the fact that what counts for any industry is its *effective* rather than *nominal* rate of protection. *What each industry cares about is not the protection that is granted to the products that it produces but to the value that it adds.* Tariff protection on intermediate inputs reduces value added, while protection on final goods increases value added. It is this basic notion that we exploit in our tariff liberalization design. By removing

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<sup>1</sup> Originally, for example under the Uruguay Round in contrast to the current 100 band system, South Africa was supposed to reduce the number of tariff rates to just six rates (0, 5,10,15,20, and 30 percent).

tariffs on inputs, we are able to limit the reductions in effective protection represented by the reduction in final tariffs. In addition, import tariffs implicitly tax exports and confer negative rates of protection. So an approach which eliminates input tariffs will also stimulate exports by reducing or eliminating these penalties.

In the simulations we show that it is possible to find a structure that (a) provides a reasonable amount of effective protection for labour-intensive final goods production, (b) confers considerable benefits on SACU consumers thereby making the system less regressive, (c) reduces taxes on exports, (d) improves the transparency of the system, (e) provides a clear norm against which temporary exceptions for industrial policy and safeguard protection could be contrasted and (f) creates incentives for a more rational approach to SACU revenue sharing. In the final section of the paper, we consider a more explicit division of the aid and tariff-revenue sharing components of the SACU revenue sharing formula. We also consider some options for SADC and South Africa's trade relations with other African countries, in particular emphasizing the role of Free Trade Agreements rather than additional customs unions.

In focusing trade policy on these issues, we are aware that we are swimming somewhat against the tide. In recent years, the tariff structure has not continued to be a focus of policy. In part this reflects the view held by some, that the benefits from previous trade liberalization have been disappointing. In particular, that while it stimulated imports; liberalization did little to promote exports and thus contributed to the weak performance of employment growth in tradable goods. It also reflects a belief that liberalization efforts in other developing countries and African countries in particular, have produced disappointing results.<sup>2</sup> Industrial and other policies designed to improve productive capabilities are seen as necessary for these countries to become competitive exporters of manufactured goods. Accordingly, there are many who argue that before

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<sup>2</sup> Turok, B. (2007) "South Africa: EU agreement has "not been beneficial," [www.bilaterals.org](http://www.bilaterals.org) [accessed May 2007]. See Also World Bank (2006), Lall and Kraemer-Mbula (2005) and Shafaeddin (2005).

South Africa undertakes further changes in its trade policy it needs to determine its overall industrial policy strategy. The DTI (2006: 11), for example, argues that “Industrial policy must lead trade policy more explicitly”. A further view is that unilateral reform cannot take place until the institutional structures as outlined in the 2002 SACU Agreement are established. Under this agreement changes to SACU tariff policy will be negotiated by *all* SACU members and decisions will be arrived at by consensus. Finally there is a view that whatever liberalization is undertaken should not be unilateral but instead implemented in the context of trade negotiations so that reciprocal concessions can be obtained from trading partners.<sup>3</sup>

The result is that South African trade policy appears to be in a holding pattern awaiting the development of an industrial policy and the conclusion of the Doha Round. But in our view, even if they do not implement it immediately, it could be helpful if South African trade policymakers had a clear idea of the direction in which trade policy should be moving and the general attributes of the approach that should be adopted. Without an understanding of what an appropriate tariff structure would look like, South Africa could find it difficult to respond to proposals in the Doha Round and in its regional trade negotiations. More importantly perhaps, clear guidelines on the desired structure of the tariff schedule and rules governing tariff changes are actually required for effective implementation of industrial policy. Reform of the current SACU tariff structure is therefore a pre-requisite for the development and implementation of a future industrial policy.

We should add that it is certainly true that for some South African producers, trade liberalization in the 1990s entailed painful adjustments. But two points about this previous experience need to be stressed. First, South Africa was protecting many activities that were

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<sup>3</sup> This view is reflected in the DTI Industrial Strategy Document (2006: 22): “SA’s negotiating objectives in the WTO and bilaterals are aimed at: enhancing market access for products of export interests; eliminating industrial country subsidies and support to inefficient producers, particularly agriculture; and re-negotiating rules that perpetuate imbalances in the international trade regime.”

simply not viable without that protection – permanent infants -- and thus the previous policies were extremely inefficient and ultimately unsustainable at reasonable cost. Second, as we argued in our earlier paper, (Edwards and Lawrence, 2006) the regime was particularly discriminatory against the development of non-traditional exports. All in all, the evidence appears to indicate that the net impact of the liberalization on employment was actually fairly neutral over the 1990s (Edwards, 2001) and as Edwards and Lawrence demonstrate it did stimulate exports of non-commodity manufactured goods. Thirdly, there is growing empirical evidence that trade liberalisation explains much of the improvement in productivity growth experienced in South Africa during the 1990s (Jonsson and Subramanian, 2001; Harding and Rattsø, 2005). Fourth, we advocate accompanying these measures with specific adjustment programs (see section three).

We believe that a radically simplified tariff structure should be implemented as soon as possible. However, we also believe that political and strategic decisions as to the timing and phasing in of implementation and the use of additional liberalization as a bargaining chip in the context of multilateral and regional negotiations are matters best left up to South African political decision-makers.

We should add three further prefatory remarks. First, by focussing on the tariff structure, we certainly do not mean to imply that it is a panacea, or a substitute for other policies designed to enhance SACU's international competitiveness. Indeed, we advocate it as a complement to other forms of industrial policy, (See the papers by Hausmann, Rodrik and Sabel for this project). While we argue there should be a simple, generally applicable, tariff rule, we would still allow for a few priority sectors to be given exceptional tariff treatment on two grounds. On the one hand, industries that merit some form of infant industry protection; and on the other hand, industries that experience particularly difficult adjustment challenges (“substantial injury due to imports”) and merit protection in the form of temporary safeguards to limit dislocation. In both cases, however, the “rule” whereby these exceptions are granted needs to be defined.

But we would like to eliminate distinctive treatment between industries in the absence of a sound reason for doing so. Our analysis of the current structure, by contrast, suggests that much of it is simply a reflection of the relative strengths of previous sector lobbying efforts. As a result, it is riddled with inconsistencies and arbitrary decisions that have inadvertent effects.<sup>4</sup> At a minimum, the basis for differential treatment is not explicit and thus, even if protection was justifiable at some time in the past, it is hard to know if the original basis for that protection still prevails. It is inadequate to simply invoke the mantra of “infant industry” protection to justify whatever the existing level of tariffs is. The infant industry rationale must be justified on the grounds that the social costs of protection today will be more than offset by the gains from developing an industry that will be competitive in the long run. But we will show below, that the current tariff structure is not actually designed with a view to developing industries that can eventually become competitive. It appears, instead, as though currently the reason for trade protection is the idea that it is better to make things locally than to import them. But this is a very weak rationale since it ignores the potential gains from trade and the costs of this behaviour need to be taken into account.

Second, it is important to remember that South Africa currently allows its exchange rate to float freely. As a result, protection keeps the exchange rate stronger than it would otherwise be. If protection is applied inefficiently, it imposes additional costs on the economy by hurting other sectors that could benefit from a more competitive exchange rate. By contrast, trade liberalization would weaken the Rand and help spur producers that at the margin are more efficient in exporting and/or competing with imports.

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<sup>4</sup> Consider, for example that in 2004 tariff rates on fish included Salmon, Trout, and smoked fish at 25 percent while Tuna, Sole, Halibut, lobster and crabs were duty free. Rates were 35 percent for mangoes, 20 percent for strawberries, 15 percent for pineapples, 10 percent for dried apricots, 5 percent for bananas, oranges, grapes, pears and kiwi while nuts were duty free. Because black fermented tea was subject to a specific rate of \$647.08 per ton, the *ad valorem* equivalent rate for packings greater than three kilos (kgs) was 29.53 percent but it was just 7.56 percent for packings less than 3 kgs. It is hard to understand why social welfare is enhanced by encouraging tea to be imported in small packings!.

Third, in providing simulations that use specific numbers and classification schemes we do not intend to claim that they are necessarily the best ones. We simply mean to illustrate general approaches. In particular, to show how the principle of effective protection can be exploited to generate improvements and simplification. Ined, it is likely to be the case, that after further investigation and research, those responsible for tariff policies will come up with a different and more appropriate set of rates and classification system. But if, through this analysis, we can stimulate the exploration of such options, we will have achieved our purpose.

## Section 1: Features of the current tariff structure

In this section we explore several features of the current SACU tariff structure. In particular, we consider several measures of its restrictiveness, its effects on taxing exports and its complexity.

**Table 2: Summary of SACU tariff schedule**

	2006			
	2006 MFN AVE	2006 EU AVE	2006 SADC AVE	Total
<b>Simple Average</b>	8.2%	4.8%	0.1%	4.4%
<b>Import weighted averages</b>				
<i>All goods</i>	7.4%	7.9%	0.0%	7.3%
<i>Final goods</i>	20.2%	16.8%	0.3%	18.6%
<i>Inputs</i>	5.8%	8.5%	0.0%	6.5%
<b>Trade Restriction Index</b>				
<i>All goods</i>	14.8%	16.9%	0.8%	15.2%
<i>Final goods</i>	25.8%	26.7%	2.4%	26.0%
<i>Inputs</i>	12.3%	17.7%	0.9%	14.2%
Max	108%	108%	60%	108%
sd	11%	8%	2%	
coeff var	1.36	1.65	15.73	
<b>Frequency</b>				
less than or equal to 0%	53%	66%	99%	73%
0% < #lines ≤ 5%	7%	2%	0%	3%
5% < #lines ≤ 10%	9%	5%	0%	5%
10% < #lines ≤ 15%	10%	18%	0%	9%
15% < #lines ≤ 20%	8%	2%	0%	3%
20% < #lines ≤ 30%	9%	6%	0%	5%
more than 30%	4%	1%	0%	2%
<b>Total lines</b>	6,670	6,673	6,673	20,016

Note: Passenger vehicles are included as both final goods and inputs (intermediate and capital goods). Ad valorem equivalents using 2006 import unit values are calculated for all non ad valorem rates.

**Protection.** As is evident in Table 2, by the most relevant measures, protection actually remains quite significant in SACU even though a simple average of 2006 tariffs seems to indicate that the economy is quite open. The simple average of tariff lines, for example, is just 4.4 percent. However weighting lines by import shares raises the average rate to 7.3 percent. And, as is well known, simple averages may understate protection for three reasons. They may use the wrong

weights, fail to take account of tariff variability and overlook the interactions within the tariff structure (through tariff escalation for example).

The problem with conventional import- weighted measures is that high tariffs will lead to low import volumes so the weights are biased downwards. In addition, import-weighted averages are poor measures of the welfare effects of tariff protection which, (with linear demand and supply curves) are proportional to the square of the tariff rate. The full extent of tariff distortion (size of the deadweight triangle) will be a function of both the height of the tariff as well as the elasticity of demand and supply. Thus, even if the average level is ten percent in both cases, if all tariffs are ten percent, there will be much less deadweight distortion than if half are zero and the other half are twenty percent.

*Trade Restrictiveness Index.* To capture these considerations, we follow the work of Anderson and Neary (1994) to construct a trade restrictiveness index (TRI). We use the approach described in Feenstra (2005). The TRI is a measure of the uniform tariff that if applied to imports instead of the current structure of protection would leave home welfare at its current level.<sup>5</sup> We calculate the TRI using 2006 tariffs for SACU and detailed product import elasticities obtained from Kee et al. (2004).<sup>6</sup> This calculation indicates that import weighted average tariffs underestimate the restrictiveness of trade as measured by the uniform tariff TRI equivalent by

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<sup>5</sup> The TRI index can be calculated as:

$$TRI = \left[ \frac{\sum_n m_n \varepsilon_n T_n^2}{\sum_n m_n \varepsilon_n} \right]^{1/2}$$

where  $m$  is the import value,  $\varepsilon$  is the elasticity of import demand and  $T$  is the tariff. The TRI is therefore the weighted sum of squared protection levels, where weights are given by the elasticity of import demand and imports.

<sup>6</sup> Hiau Looi Kee, Alessandro Nicita, Marcelo Olarreaga, 2006. Estimating Trade Restrictiveness Indices. The HS6 digit elasticities are applied uniformly to all sub-digits. Where no map was found, the simple average Hs4 digit elasticity was applied.































































































































































