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SACU Revenue Sharing Formula: *Towards a Developmental Agreement*

Roman Grynberg
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BIDPA

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Abstract

The South African Customs Union (SACU) Revenue Sharing Formula (RSF) has been revised substantively twice; once in 1969 and in 1994-2002 since the creation of the customs union in 1910 and each time the changes in the treaty were a reflection of the historic changes occurring in Southern Africa. The apartheid regime created a RSF that served to increase the share of revenue of Botswana, Lesotho and Swaziland (BLS), leaving the South African share as a residual of revenues. As this made South Africa a residual claimant it was unsustainable and required reform in the post-apartheid era. The 2002 formula increased the share to the Botswana, Lesotho, Namibia and Swaziland (BNLS) and removed South Africa as a residual claimant but did not change the fundamental economic relationship between members. While the International Monetary Fund (IMF) supports orthodox fiscal adjustment imbalances this paper argues that the order of magnitude makes those adjustment implausible and a new political arrangement is needed between South Africa and Lesotho and Swaziland to create a viable way forward for Southern African Development Community (SADC). It is argued that even in the case of Botswana and Namibia a new developmental formula, based on investing SACU revenues for regional and national development projects is needed to relieve those countries that have suffered the effects of polarization.

Key Words: Southern African Customs Union, Revenue Sharing Formula

1. Introduction

The purpose of this paper is to examine the evolution of the Southern African Customs Union (SACU) revenue sharing formula (RSF) and propose a new developmental approach where SACU revenues are used for investment and development rather than for the general revenue. This paper does not attempt to review the three SACU treaties per se and they are discussed only to the extent that their other provisions bear directly on the distribution of revenues from the customs union. There has been adequate and extensive commentary by many authors (Kirk and Stern, 2005; McCarthy, 2003)[1]. In the first section there will be a historical review of the SACU RSF from a Botswana perspective. It is considered through its various iterations over the last century. It will be argued that the SACU RSF has been a bell-weather and a reflection of the history of southern Africa. The initial formula and the two reforms have been preceded by seismic historical changes in the geo-politics of the region- the creation of the Union of South Africa in 1910, the independence of Botswana, Lesotho and Swaziland (BLS) in the mid-1960's and the end of apartheid which signaled the commencement of the 1994-2002 renegotiations. Each change in the formula has been preceded by historical events which set the scene and were necessary conditions for the relationship to evolve and deepen.

In the second section of the paper the historical experience from other customs unions, the theory of the distribution of customs union revenue, and the more significant studies on this in the SACU region are considered along with the stability conditions for RSF. In the third section the distribution of the revenues between SACU members is considered under various scenarios with an emphasis on the case of Botswana. The impact of a shift to a 'development funding' as opposed to general revenue transfers as broadly envisaged by South Africa would impact Botswana and the other Botswana, Lesotho, Namibia and Swaziland (BLNS) is also considered.

The SACU member states have rejected the approach to the revision of the formula taken by the consultants in a recent SACU study (CIE, 2011) and have decided instead on a political and hence negotiated approach. It is argued that the most serious issue for SACU and by extension Southern African Development Community (SADC) is not the price raising effect of the customs union, which has been at the heart of the SACU compensation since 1969, but rather the impact of the more intractable problem of polarization of production benefits to members. Without an adequate resolution of the issue of polarization effects of the customs union, neither SACU nor, by extension, SADC will be in a position to widen or deepen their integration.

The situation as it pertains to Swaziland and Lesotho which are the countries that would be the most severely affected by any structural shift away from the 2002 RSF is also considered. In the final section a revised developmental approach to SACU revenues is considered which reflects the needs of members to transform their economies and to reverse the effects of polarization on the BLNS.

2. The SACU Revenue Sharing Formula and Botswana – A Brief History

Each of the renegotiations of SACU RSF were in theory technical revisions of a treaty arrangements but all three were linked to and preceded by political events in the region. The creation of SACU in 1910 was a direct result of the creation of the Union of South Africa in 1910. The 1969 renegotiation followed immediately after the independence of the last of the Botswana (1966), Lesotho (1967) and Swaziland (1968). These 1969 renegotiations signaled a fundamental rebalancing of the benefits of SACU RSF in favour of Botswana and the then BLS in general[2]. A further round in 1994-2002 was necessary to rebalance the formula, but the net outcome remains fundamentally politically unstable.

2.1. The creation of the Union of South Africa - 1910 SACU Agreement

Botswana, then Bechuanaland, declared its first customs tariff in 1892 and by 1893 joined, Basutoland, Cape Colony and the Orange Frees State in a customs union[3]. Under that arrangement tariffs were charged on goods entering the customs union in Cape Town and 75% was remitted back to Bechuanaland, the balance being held in lieu of the cost of administration of the customs union. At the end of the Anglo-Boer war in 1903 yet another customs union was formed which included Cape Colony, Natal, Orange Free State, Transvaal and Southern Rhodesia. Bechuanaland and Basutoland were included without consultation, a matter to be repeated when SACU was formed seven years later[4].

With the formation of the Union of South Africa in 1910 there was a need for a common external tariff (CET) for all the former Boer states and British colonies. The view of Britain at the time was that the Protectorate of Bechuanaland and the other two territories would be eventually absorbed into the Union[5]. In July 1910 Lord Gladstone, then High Commissioner to South Africa, Bechuanaland, Basutoland and Swaziland ‘signed in four places’ for each of the four countries and protectorates under his mandate and the SACU was created (Ettinger, 1975)[6]. Under the 1910 SACU agreement[7] the tariffs structure was to be that determined solely by the Union of South Africa and the territories and protectorates were in effect obliged to maintain a tariff similar to that which existed in the Union (Preamble). The first RSF or the Potchefstroom Formula[8] as it was called, was effectively fixed for a period of 55 years until it was finally revised in 1965 under the Lewes Formula which redistributed the shares of the BLS but maintained the South African share.

Table 1: "Distribution of Customs, Excise and Sales Revenue under SACU (1910)"

Country	Potchefstroom Formula (1910)	Lewes Formula (1965)
Basutoland	0.88575	0.47093
Bechuanaland	0.27622	0.30971
South Africa	98.68903	98.68903
Swaziland	0.14900	0.53033

Source: Report of the Ministry of Overseas Development 'The Development of the Bechuanaland Economy' November 1965, Published by the Government of the Republic of Botswana, Gaborone, page 87

In 1925 South Africa, exercising its rights under the 1910 agreement, passed the highly protective Customs Tariff Act in an attempt to industrialize its own economy and significantly raised its external tariff (Lumby, 1983). This had three effects that have been the focus of revenue sharing debates between the SACU members ever since. First, the move would decrease the revenue pool for the BLS as more goods were produced in South Africa rather than imported. Second, it would cause trade diversion to higher cost production inside the customs union and lastly it would further exacerbate the economic polarization that is normal when such partners of vastly unequal production capabilities enter a customs union. At the same time as South Africa was protecting its own industry in the mid-1920's it was prohibiting the only export that Batswana could export, namely cattle through weight restrictions (Ettinger, 1972). The weight levels (1,000 lbs for oxen, 750 for cows) were set at levels that white farmers in Bechuanaland could meet but were generally not possible for traditional Batswana cattle farmers. All that was left was for Batswana to export was their labour to the South African mines.

By 1968, just prior to the negotiations with South Africa, the share of trade of the BLS had risen to 4.1% of the total SACU imports while the revenue share remained 1.3%, i.e. unchanged from the 1910 formula[9]. From the South African perspective, its share of the RSF was seen as immutable but from the perspective of the BLS the revision was seen as vital to an equitable redistribution of benefits of the customs union. Whether the BLS were in effect subsidizing South Africa at the end of SACU 1910 agreement cannot be known without a detailed analysis of the applied tariffs and the composition of trade[10]. It was certainly the view of commentators at the time that Botswana could affect a superior revenue arrangement outside of SACU at relatively low cost. However, the view of the British government had long been that the 1910 formula had provided the BLS a disproportionate share of benefits simply by virtue of the fact that the rate of economic growth in South Africa had been much faster than in the BLS. Therefore a formula which provided the BLS with a fixed percentage of a rapidly growing import base was certainly more than could otherwise be achieved by the BLS from individual tariff regimes. With the independence of the BLS and ensuing high growth rates, and the declining growth in South Africa, this was no longer the case.

2.2. Independence of Botswana, Lesotho and Swaziland and the 1969 Renegotiations

The renegotiation of the 1910 SACU agreement in 1969 which occurred following the independence of BLS saw a fundamental shift in the position of South Africa and a greater willingness to offer a RSF that was more closely linked to the negative externalities of the customs union. The position that there were substantial net benefits of SACU to Botswana was a position maintained by the UK government until independence[11].The views of the independent government of Botswana were quite different from that of the British government as the perception was that trade diversion along with polarization significantly outweighed the benefits of not having to pay for a customs administration. Prior to the 1969 negotiations there had been considerable analysis undertaken by the Botswana government on the implications of leaving SACU as well as intensive consultations amongst the BLS. The Botswana government's first development plan issued on Independence Day in 1996, made the government's desire to negotiate a more equitable arrangement very clear[12]. In the final analysis what was negotiated was a radically different RSF from that of 1910 or any other customs RSF because it removed the linkage between the revenue derived by the BLS from the size of the total revenue pool. Importantly, the new RSF was based not on the share of extra-customs union trade but on all imports, including imports from within the customs territory, that is South Africa (Article 14.2)[13]. In many ways this formula resembled the principle underlying the RSF in the Australian constitution which was based on total consumption[14]. Most importantly the new formula left the South African share as a residual after the BLS were paid.

The 1969 agreement also had a sinister side in the form of a secret memorandum that was only made public in the 1990's following the end of apartheid. The memorandum set in place a mechanism whereby a member could not seek infant industry protection through the external tariff to protect a local industry if it was not capable of supplying 60% of the SACU market[15]. This in effect precluded the BLS from ever using infant industry policy instruments within the context of the customs union to develop local production as no facility based in a BLS country, could at that time, have possibly supplied such a large portion of the SACU market. This loss of trade policy is seen by many contemporary economists as one of the reasons for Botswana's relative success[16]. This argument is fallacious because this type of restriction meant that the only significant trade instrument still available to the BLS was border closure, on a partial on a complete basis. All SACU members, including the BLS continued to pursue import substitution policies but based on small inefficient markets with some very high costs[17]. Only South Africa had recourse to the external tariff as a vehicle for industrial development. This resulted in industry being developed in the BLS that was confined to these small markets and never able to reap the benefits of economies of scale that the SACU customs union potentially created. The polarisation of

production in SACU that would naturally occur between small and large nations in a customs union was therefore, not only exacerbated by the terms of the memorandum but legally cemented and the path to inward looking, sluggish sub-economic import substitution policies within the context of micro-states commenced. Botswana therefore made a Faustian bargain and traded its right to a more effective trade policy in a customs union of then 20 million people for the revenue generated by a favorable RSF. Herein lies one of the sources of apartheid era polarization. For Botswana, dependent as it was at the time on highly unpredictable but declining transfers from the United Kingdom, and with its rich diamond mines still to be developed, the choice seemed obvious. From the perspective of policy makers in apartheid South Africa the terms of the memorandum guaranteed the BLS as captive markets rather than potential industrial threats, little 'Hong Kongs' undermining the competitive position of South African industry. Polarization which was assured by natural forces of agglomeration since 1910 was legally institutionalized in 1969.

Under the revised formula South Africa's share of the revenue became a residual after the BLS were paid their share. The introduction of the multiplication of the BLS share by 1.42 was never explained. However, it was argued at the time that the factor was recognition and compensation by South Africa of the cost raising and polarization effects of the customs union[18]. Given the order of magnitude of the cost of these polarization effects there is in principle no reason why they could not exceed the size of the revenue pool and the 1969 formula created precisely such a possibility. As we shall see it is this element of the formula, with a potential for unlimited liability for compensation to the BLNS for the negative externalities that were created as a result of the trading relationship that was certainly politically unsustainable in the post-apartheid era.

From the perspective of any customs union RSF the 1969 SACU formula was exceptional and most peculiar[19]. The linking of revenue of the BLS to intra-SACU as well as extra-SACU imports, irrespective of whether those were re-exports or had been substantially transformed inside the customs union had no apparent precedent. However, the underlying principle of compensation towards poorer and smaller member of the customs union was embedded implicitly in German *Zollverein* RSF as well as the equalization payments of the European Union (EU). The logic behind South Africa's agreement to a formula that was to expose its revenue to such considerable long term risk was seen as a product of that country's increasing international isolation stemming from apartheid combined with the unexpectedly high rates of economic growth in the BLS (McCarthy, 2003). Of the known revenue formulas employed by customs unions this formula, based, *inter alia* on intra-union imports of originating product, was certainly unique and has remained so ever since[20]. While there was no explicit reference in the text of the 1969 agreement to the 42% 'compensation factor' it was widely recognized that this loading was in

fact compensation for two effects, the price raising effect and the polarization effect whereby tariffs raised prices in the BLS and industry tended to be located in South Africa. This was certainly the view of the Botswana government[21].

What did the change in formula mean for Botswana in particular? Prior to 1968 the effective rate of duty for Botswana was very low for a developing country (see chart 1). Writing prior to the revision of SACU, the Economic Survey Mission concluded[22] that '....the current yield of import and excise duties (little more than 10% of the estimated value of imports) is very small'. However, with the new revenue formula, that yield was supposed to increase to 20% of imports. According to Landell-Mills, in the first year of operation of the new agreement, the revenue of the BLS almost trebled over and above what would have been available under the Lewes formula

Table 2: Budgeted and Actual 1969/70 Revenues from Customs (rand)

Country	Budgeted (1910 Agreement)	Actual (1969 Agreement)
Botswana	1,870,000	5,030,000
Lesotho	1,850,000	4,900,000
Swaziland	2,710,000	7,080,000
Total	6,430,000	17,010,000

Source: Landell-Mills op cit page 276

In Botswana actual revenues from customs duties rose from ZAR 1.4 million in 1968, the last year of the Lewes Formula to ZAR 5.14 million in 1969/70[23], the first year of the operation of the new formula. The growth of the importance of customs duties in the total revenue immediately thereafter was spectacular. The development of the Selebi Phikwe Copper/Nickel Mine and the resulting surge of imports, the introduction by South Africa of sales tax in 1969 along with the substantially improved revenue formula that had been negotiated resulted in the Government of Botswana being able to balance its budget without direct budgetary support from the UK in 1972/3 (Hermans, 1974). Thus the dependence on revenue from Britain had been shifted to a dependence on Pretoria and the new SACU revenue formula[24].

The negotiations over the 1969 formula were by no means over and the RSF was to be revised once again in 1976. Following the oil shocks, the Soweto uprising and ensuing economic fluctuations in the South African economy, revenues accruing to the BLS began to fluctuate significantly from year to year as a result of the fluctuations in the size of the revenue pool. In order to address the concerns of the BLS, South Africa agreed to a revenue stabilization formula which guaranteed the BLS support unless the revenues received were above 17% but no greater than 23% or approximately 20% of total imports on average. This further decoupled the BLS

share from the actual size of the revenue pool and as imports into the BLS grew and import duty revenue declined, the share of South Africa in the revenue pool also began to decline[25]. Thus between the compensation factor and the new stabilization factor made the new multiple 1.77 rather than 1.42 (Leistner, 1995). As we shall see below this made the 1969 agreement politically unsustainable and as a result the subsequent 2002 renegotiations were essential in order to stave off a situation where SACU revenues to the BLS would, as a result of the residual status of South Africa's earnings, derive the entire revenue pool.

From a purely economic perspective it is difficult to comprehend the logic of those in Pretoria who agreed to the 1969 provisions of the RSF. Clearly, there was never a belief that the economies of the BLS would grow as rapidly as they did in the first years of independence. This was particularly so for Botswana with its new diamond as well as base metal mines which resulted in unprecedented rates of economic growth and imports. From a political perspective however it made considerably more sense. The apartheid regime needed allies or at least those who could not readily afford to be overly critical and believed that these sorts of provisions in the SACU Agreement would buy support. The RSF in 1969 and the revision in 1976 was aimed at assuring BLS remained part of the South African economic orbit. However, by decoupling payments to the BLS from the actual revenue pool what was created was a formula that created the potential for a substantial liability on South African treasury, the legacy of which the post-apartheid regime is still grappling with. The prospect of very rapid growth in BLS imports and revenue may have been foreseen but there is no evidence that the South African government was aware in 1969 or 1976 that the revenue formula would ultimately prove as problematic as it was to become by the 1990's.

What is not commonly understood of the 1969 RSF was that its sustainability was undermined under the many economic pressures created by the apartheid regime and the struggle against it. Inside South Africa the anti-apartheid struggle saw economic growth rates fall while economic growth rates in the BLS increased[26]. This decreased the size of the pool while at the same time the increased imports of the BLS increased the liabilities incurred by SA. Furthermore, the decision by South Africa during the apartheid era to use its share of the SACU common revenue pool to disburse funds to the so-called 'independent entities' which the apartheid regime called '*bantustans*', based on a formula equivalent to the 1969 SACU revenue formula put further pressure on the revenue pool's sustainability. Finally, in the late 1980's it was becoming evident that the share accruing to the BLS was growing beyond politically sustainable levels. With the imminent independence of Namibia and the resulting increased liability that this would entail it was clear for South Africa that the 1969 formula would have to be revised.

2.3. The End of Apartheid – 1994-2002 SACU Renegotiations

The renegotiation of SACU Agreement in 1994-2002 was not simply about a revenue formula. It was a renegotiation between sovereign states and the entire foundation was to be predicated on *de jure* equality between the contracting parties. Many of the new provisions of the SACU 2002 agreement were about the establishment of tariffs and excise as well as the operating modalities of the new SACU. Tariffs and excise were no longer to be the sole purview of South Africa and in theory at least all members were to have a say. This is an important contrast to the 1969 agreement where there was no pretense of equality between the members and all decisions regarding tariffs and excise remained the prerogative of South Africa. These changes were emblematic of the end of the apartheid era and were concessions of great importance to the BLNS. However, the fundamental reality on the ground of a membership with vastly differing technical capacities to deal with trade policy issues cannot be changed by treaty alone.

When it came to the RSF the negotiated 2002 RSF eliminated the down-side risk to the South African treasury that it could end up eventually paying the BLNS more than the value of the common revenue pool but in the process further increased the share accruing to the BLNS at the expense of South Africa (Kirk and Stern 2005). Whether in retrospect Pretoria's concern that the 1969 formula would ever have exhaust the SACU revenue pool is another matter. Devising an agreed formula which would simultaneously eliminate the down-side risk for Pretoria without undermining the BLNS revenue explains in part why the 1994 negotiations were so protracted.

The new RSF was based on three separate components[27]. The first component of the new formula was a division of customs revenue on a new basis which made no reference whatsoever to imports from outside the customs union. The share of each member was to be based on the share of intra-SACU imports. Thus the formula had gone full circle from 1910 and now, rather than being dependent upon imports from outside the customs union, the share was based only on internal trade. Due to the economic polarization which occurs within the SACU customs unions the structure of trade that had emerged between the BLNS and South Africa over the years has meant that the vast bulk of the customs pool would go the BLNS but at least South Africa would obtain a portion of those revenues by entitlement rather than as a residual under the 1969 formula. Thus the RSF based on intra-SACU imports should be seen as a way of compensating for structural polarization.

The second component was the excise revenue. This was further divided into two components, the first being 85% of the total excise revenue which was disbursed purely by the share of the Growth Domestic Product (GDP) of each of the SACU members. The second component, the remaining 15%, was a development component

which was instigated at South Africa's behest. This portion of the revenue would be distributed in inverse proportion to the GDP per capita of each member. Thus the poorest members of SACU would receive a disproportionate share of this element of the excise. As a result, this particular share would end up being distributed in roughly equal portions to all members. The development component was therefore in essence an equalization fund. While it was considered to be an equalization fund, it went to general revenue for all SACU members and there was no assurance that the resources would be used for development projects by members[28].

The British had pushed the BLS into SACU during the colonial era with a revenue formula that was, by the time of independence seen by the BLS as not being in their interests. The apartheid regime then created an unsustainable revenue formula in 1969 between themselves and the BLS which were not legally equal parties as tariffs and excise were determined by one party alone. The 1969 RSF had to be revised in order to assure that the revenue accruing to South Africa from SACU did not become negative. There is no economic reason why a RSF which aims to compensate members of customs union for negative externalities that it generates should not yield such an outcome. However, politically a negative share for South Africa would have been extremely difficult to justify on political grounds. To obtain BLNS agreement to this reform of the RSF, the post-apartheid government in Pretoria had to agree to the customs component being shared on the basis of intra-SACU imports which in the end further increased the share and dependence of the BLNS on SACU revenues. However, at least it gave South Africa a fixed share of customs revenue and not a residual which eliminated the possibility of the politically unsustainable outcome for South Africa.

3. Revenue Sharing Formula in a Customs Union

3.1. RSF in other Customs Unions

An understanding of SACU would certainly be deficient without some consideration of the important historical precedents. The German *Zollverein* along with the customs union created by the Commonwealth of Australia at federation in 1901 was the precedent which, if British policy makers considered revenue sharing for their territories and protectorates at all, would no doubt have had in their minds when they forced the disparate southern African states into a customs union in 1910. The German *Zollverein*, like the original SACU agreement was a direct result of war (Henderson, 1939). The German *Zollverein* was a result of the Congress of Vienna which ended the Napoleonic Wars and SACU was the direct result of the end of the Anglo-Boer War and the creation of the Union of South Africa. However, unlike the *Zollverein* or the Australian Commonwealth, SACU was not a result of the will of the individual parts of the customs union but rather the result of British colonial policy in the region to bring the various Southern African states into a larger economic

entity capable of generating sufficient revenues so as not be a burden on the British exchequer (Ettinger, 1974). In the early 19th century when the *Zollverein* was formed from the 300 plus customs areas of the *Deutschebund* for a RSF that benefited the smaller states was one of the very important factors that kept *Zollverein* together. The revenue sharing in the *Zollverein* was ultimately based on a per capita basis (Milward and Saul, 1973). This meant the poorer members of the customs union received a disproportionate share of the revenue. However, even this simple formula required the development of the German census so as to assure a quantitatively accurate distribution.

The Australian Commonwealth was a federation of former British colonies which federated into one nation in 1901. What was agreed, at least initially in their customs union was the distribution of revenues was to be done according to consumption levels[29]. However, modern economic literature, to the extent that it considers revenue sharing at all, almost invariably assumes that members agree to a technically neutral distribution based on the absorption of extra-union imports as was the case with the SACU 1910 formula and the Franco-Italian Customs Union of the 1940s (Syroupolos, 2003).

Even had Britain wanted the *Zollverein* or Australian RSF in 1910 the data simply did not exist for the BLS but the extra-SACU import data was readily available given that there were, at the time, only two points of entry to the customs union -Cape Town and Durban. Ideologically, the *Zollverein* was a direct result of the need to create a unified market in which German industry could flourish and compete with Britain. A similarly strong protectionist motivation also underlay the formation of the Australian Federation.

Contemporary customs unions, especially those in Africa and other developing countries and regions, have tended to avoid the sorts of politically difficult problems of a RSF like the one employed by SACU by using a technical formula based on the revenue directly derived by the country of final destination as the basis for revenue raising and collection at the country of final destination i.e. akin to the 1910 formula. This is true of the Andean Community, Caricom, Cemac, East African Community, the Gulf Co-operation Council, Mercosur, and the West African Economic and Monetary Union. Only in the case of the latter is there an equalization fund for three of the poorest landlocked countries[30]. The East African community is scheduled to return to the question of the RSF in 2011.In the case of the EU, where the import duty revenue retained for the use of the community and not distributed to members except 25% for the cost of levying import duties.

The revenue sharing approach to dealing with externalities has largely been discarded and most recent customs unions have moved to the extra-union trade as determined by imports at the country of destination as the method of sharing revenue. This is the standard approach taken in economic literature where there has been little discussion of this matter (Syropoulos, 2003)[31]

3.2. Transactions Costs, Entrepot Trade and Revenue Sharing

In the absence of any externalities or redistribution objectives of the members of a customs union, the customs revenues derived by each member of the union should be based on the external tariff leveled at the point of entry of the goods into the union and the agreed non-originating intermediate goods entering the border of the country in question. If countries are willing to accept such a formula as a purely 'technical matter' as is the case in most customs unions in developing countries then there is no reason for any dispute over revenue sharing. In the case of SACU the calculation of the revenue based on the point of first entry is in large part a result of the fact that throughout most of its life the smaller SACU members were all landlocked and raising duties in Cape Town and Durban diminished the transactions cost of trade and the cost of raising revenue. The destination approach would have raised considerably the transaction cost of trade in SACU and was among the original reasons for SACU. However, the high administrative cost of the numerous disputes over revenue sharing in SACU would certainly be an important counterweight.

If we make the patently false assumption that there are no external benefits or costs of membership from a customs union, or that those benefits are distributed in accordance with the share of trade, then what a RSF should ultimately be based on is the revenue that would otherwise be derived from imports into the customs territory and destined for each member i.e. the destination principle or, in the context of SACU, a slight variant of the 1910 formula. Thus the formula for the revenue accruing to a member of customs union is normally assumed in contemporary economic analysis to be the revenue raised on extra-customs union imports[32].

There are three sources of trade transaction related externalities that should render a customs union a Pareto improvement for all members of the customs union and therefore there should be no need for a transfer or compensatory payment. The first is the decreased cost of customs administration which accrues to all members, especially, when in the case of SACU all revenue is collected at the point of first entry. The second stems from the increase in entrepot trade which will naturally occur with any customs union as more commodities are purchased from outside the customs area in bulk and reconsigned to individual members. This creates added economies of scale which often substantially lower unit of cost of imports to all members[33]. The third Pareto superior benefit which should accrue to all members of a customs is that the union creates a trade regime where there is no need for border inspection beyond the point of arrival of the good and there is therefore no need for complex rules of origin which greatly complicate trade. This is the case in the EU, for example but not the case in SACU[34]. These three together, point to some of the obvious reasons why countries create customs unions and assume that all countries, irrespective of size and economic development will benefit.

3.3. SACU, SADC and Revenue Sharing Stability Conditions

The problem of revenue sharing arises when some members of the customs union perceive that the outcome creates external costs and benefits that are not equitably distributed. These external costs and benefits are not evenly distributed which gives rise to the perceived need for compensatory payments. The transfer must not simply be seen as a matter pertaining to externalities, but as in the case of the *Zollverein*, the grandfather of all modern customs unions a RSF that benefited the smaller and poorer members was necessary in order to assure their continuing membership in the customs union. These transfers were necessary for political reasons involved in the formation of the German Empire and just as transfer payments by the EU are part of a political process involved in the formation of a larger geo-political entity. For the larger members of the *Zollverein* such as Prussia the economic benefit was the larger market for their manufactures, for the smaller members it was the increased revenue from the RSF. The beneficial externality for all members was the decreased transaction costs of trade of goods crossing many of the 300 customs territories that made up the *Deutschebund*. This mirrors the case of the SACU, where one member gains through increased market size and the ensuing lowered production costs resulting from economies of scale and the rest of the customs union members benefit through a share of the revenue as compensation for trade diverting effects. All members gain through decreased transaction costs.

The reality of a customs union is that benefits and costs are created for all members especially when there is a marked difference in their size and development. Cost raising and trade polarization effects can both occur within the context of a customs union and the burden may fall unequally on members. With the presence of unequal patterns of distribution of the net external benefits where some countries may be net beneficiaries and other net losers, the customs union will not remain stable unless three obvious stability conditions in the RSF are met:

1. The net overall benefits from the existence of the customs union are positive
2. The transfer payments to the net losers must be sufficient to compensate them for the negative externalities incurred[35].
3. The payments made by the net gainers from the customs union to net losers must be less than the external benefits the gainers derive from the arrangement.

Whether these three conditions have been met throughout the life of SACU is debatable as the BLS/BLNS have always argued that the compensation that they have received never really addressed the losses stemming from polarization or cost raising effects. However with the advent of the SADC Protocol on Trade over the 2000-2008 period the third stability condition and arguably the first has been violated. The

SADC agreement creates roughly equal market access for South Africa's exports into all SADC markets which includes all the BLNS and does not involve the level of consultation and co-ordination of a customs union. Thus the externalities derived from economies of scale derived by South Africa could be derived without any need for transfer payments to the BLNS as such payments are not part of the SADC Protocol on Trade. By agreeing to SADC Protocol on Trade the BLNS created in effect an instrument which completely undermined the principle justification for the SACU transfers. However, the problem is that the stability of the SADC Protocol on Trade itself cannot be assured without SACU transfers to the BLNS because the latter would have to breach their commitments to not impose tariffs on imports from other SADC members without these revenues. The trade off for South Africa is, as it has been for a decade, the benefits of stable market access under SACU with transfer payments or a potentially less stable SADC Protocol of Trade and the yet-to-be negotiated trilateral Free Trade Area (FTA) arrangement without transfer payments. South Africa has clearly opted for the trilateral (Comesa-EAC-SADC) FTA as a sufficient form of market access needed for it to retain its dominant position in Southern and Eastern Africa. By agreeing to the SADC Protocol on Trade, the BLNS have negotiated an instrument that undermines the stability of their government revenues and has, in part; given rise in 2011 to what are the beginnings of a revision of the RSF that will likely see a re-distribution in favour of South Africa.

3.4. Cost Raising and Lowering Effects and Polarization

3.4.1. Cost Lowering Effects and the 'SACU corner solution'

Corden (1967, 1972) provided a development of Viner's (1950) discussion of the role of economies of scale, product differentiation and oligopoly in a customs union. Corden (1972) is not normally employed, cited or recognized by most economists who much prefer dealing with competitive models with linearly homogeneous production functions where are there are no economies of scale. The absence of economies of scale is important to the classical vision of trade benefiting all parties. Corden (1972) argued that where there exists economies of scale and with a downward sloping cost curve it is common for smaller firms to vacate a particular market when a customs union is created or for the single large producer or large producers to become even more dominant once the customs union market is created. Corden was thus the unrecognized precursor of the work of Krugman and the New International trade theory almost two decades later.

The economies of scale that result from the creation of a customs union perpetuate or exacerbate production polarization of the dominant large producers. The expansion of the market created by the customs union creates what Corden (1972) called the 'cost-lowering effect' of the customs union as the dominant firm experiences lower

production cost because of its ability to capture greater economies of scale. Thus the addition of assured markets such as the BLNS lowers the cost of production for producers already existing in the large dominant market and perpetuates the position of smaller customs union members as consumers of products produced in the territory of the larger producer. This is one of the most important sources of what economists call polarization. This expansion of the market means that smaller producers in the customs union simply cannot enter unless they are able to achieve scale economies similar to that of producers from the dominant market or unless they receive transfers from a third source. The idea that a customs union creates and/or perpetuates polarization stems logically from Corden (1972)'s cost lowering effect. This in turn leads to what can be called the 'SACU corner solution' where all non-protected production for SACU occurs in South Africa and all production in BLNS is either for own-consumption or protected by high non-tariff barriers, or based on mineral extraction, or subsidized by high preferences into non-SACU markets. All production in the smaller states therefore requires quasi-rents to overcome their higher costs. This quasi-rent is generated either by the state through subvention, acts of God or Nature (the deposit of minerals), by third parties such as preference donors or lastly and sporadically by the market through niche markets. However, quasi-rents in the context of the market i.e. niche products are normally transitory and therefore are rarely a basis for sustainable long term production in smaller states (Grynberg, 2006).

3.4.2. Price Raising Effects

The price raising effect of the customs union on the BLNS has been the basis for the development of the system of compensatory transfers by its members. The price raising effect of the customs union occurs when the external tariff is raised to protect South African commercial interests. This is well understood in economic literature and a long standing method of calculating trade diversion effects exists. A great deal of analysis has been undertaken in Botswana of the impacts of SACU on trade and the pricing levels. The most significant was undertaken was that by Leith (1992) who calculated the impact of SACU tariffs on Botswana's prices, the price raising effect of the tariff. Leith (1992) calculated that based on 1987 prices and GDP the price raising effect on imports of the SACU tariff. This is the amount transferred annually from Botswana consumers to the government and firms of RSA. Leith's analysis is based on a very substantial discounting of future revenues which results from the fact that trade data is delayed and SACU members receive final payment of tariff revenues 2 years in arrears. Leith (1992) concludes that the loss to Botswana from its membership in SACU is up to 3.25% of GDP. Perhaps more significantly to the present day is the fact that his counterfactual employed by Leith (1992), that Botswana would apply the SACU tariff to all imports would not be possible for Botswana to apply under the terms of the SADC Protocol on Trade.

Leith (1992) recognizes that his analysis is not a full cost-benefit of membership in SACU and that his analysis does not cover 'the historical question of whether or not the BLS have benefited from the discipline of membership of SACU. In this regard we do not consider here whether membership has contributed to the avoidance of self inflicted policy errors found elsewhere in Africa such as excess of import substitution, domestic monopolization and macroeconomic instability'[36].

If one considers the time period over which Leith (1992) was undertaking his analysis i.e. 1985-1988 it is clear from chart 1 that the tariff equivalence of SACU revenues was at a very low level, averaging 11% tariff equivalent over the years covered by Leith's analysis. Leith (1997) later recalculated the net price raising effect of the tariff in 1997 assuming a 25% decrease in SACU tariffs resulting from the Uruguay Round commitments and found that under the 1969/1976 formula Botswana would actually gain 1% of GDP. It is perhaps worth noting that following substantial decreases in the SACU tariffs at the end of the Uruguay Round and the 2002 renegotiation Botswana was receiving 9.25% of GDP in SACU transfers in 2009. The more recent work on the economics of the SACU RSF is by Flatters and Stern (2006). These authors address the two key criticisms that the BLNS have historically leveled at the SACU agreement. The first is the question of price escalation and second, the question of structural polarization. Flatters and Stern (2006) undertake a similar, though by no means identical analysis to that of Leith (1992) for 2006 and find that the BLNS are more than compensated by customs transfers for any possible cost raising impact. They therefore argue that the BLNS are net beneficiaries of SACU.

This argument ignores the fact that the counterfactual that Flatters and Stern (2006) propose for the BLNS i.e. imposing tariffs on imported products is, as discussed above, simply not legally possible under the terms of the SADC FTA[37]. This legal obligation was entered into in 2000 and implemented by 2008 and hence the authors were well aware of its existence. Therefore, in the absence of SACU, the BLNS could only impose tariffs on non-SADC members but for the tariff to be revenue neutral given that a country like Botswana which only sources some 10-20% of imports from outside SADC, such a tariff would certainly violate the country's tariff bindings at the WTO[38]. This is more than a mere legal issue as the imposition of tariffs on a wide range of products would also undermine SADC and leave South Africa without the market access into the very region where its non-mining exports do have a considerable commercial advantage.

3.4.3. Polarization Effects

The second source of compensation to the BLNS has been the polarization effect of the customs union whereby industry becomes concentrated in Gauteng. It is important to note that polarization will naturally occur between large and small countries and regions due to the economics of agglomeration[39]. The extent of polarization in the

SACU region is reflected in the intra-SACU import figures presented in table 3 below. These show that South Africa's share of total intra-SACU imports was less than 9% of the total for 2008/9, the most recent year for which intra-SACU trade data was available. In 2008/9 South Africa exported approximately ZAR 80 billion to the BLNS.

Table 3: Intra SACU Imports (ZAR Million)

INTRA-SACU IMPORTS	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Botswana	17,165	16,520	19,083	16,879	18,233	25,253	31,898
Lesotho	8,073	7,928	8,358	8,483	9,638	9,246	10,246
Namibia	13,943	16,587	13,543	15,336	17,368	23,205	26,548
South Africa	7,045	13,099	15,162	13,424	13,598	14,770	14,809
Swaziland	12,453	10,937	10,266	10,667	10,195	9,220	10,814
Total	**58,679**	**65,071**	**66,413**	**64,789**	**69,032**	**81,696**	**94,316**
Growth rate	-	10.9%	2.1%	-2.4%	6.5%	18.3%	15.4%

Source: SACU, 2009

However, polarization is by no means an immutable force and many countries that were not long ago peripheral economies in Asia e.g. China, Taiwan, Malaysia and in Europe e.g. Ireland have reversed this trend through their own industrial policies. The various SACU treaties merely exacerbated what would otherwise have occurred through the natural economic forces that drive agglomeration to areas of high economic density. But the important work of Krugman and Venables (1995) has highlighted that a U-shaped relationship develops over time whereby agglomeration of industry in high density areas increases at first and then declines when falling wages and transport costs shift industry to the periphery. This is what one finds in terms of the movement of industry from Japan to East Asia since 1975 and from the US north east to the South after the 1940's along with the movement of industry away from the north of Europe to the south and more recently the east. What is of particular concern is why there has been no similar tendency in SACU for the forces of agglomeration to be reversed from the centre to the periphery as has commonly been the case in other regions. While the impending SADC treaty resulted in a flurry of research on polarization (Hess 2002, Peterson 2000, McCarthy 1999) there seems little research on polarization in SACU and little evidence of industry leaving Gauteng after a century of integration.

Flatters and Stern (2006) attempt to address the issue of polarization and argue, incorrectly that 'discussions about polarization are based on the substantial differences in per capita incomes, growth rates and other development indicators among SACU member states'. Polarization reflects the concentration of production in a particular location. They argue that for some of the BLNS such as Namibia

and Botswana incomes are similar, if not higher than that of South Africa, and others such as, Lesotho are not. The authors argue that income disparities, in line with the macroeconomic literature of convergence, are a measure of polarization. However, levels of GDP per capita in the BLNS have everything to do with initial endowments per capita and very little to do with SACU[40]. Moreover, structural bilateral trade imbalances can occur with or without polarization. The only logical statistical measure of polarization in a customs union is the share of total imports by one partner to another partner and it is for this reason that the 2002 SACU formula should be seen as a compensation for economic polarization not for cost raising effects. What is certainly a more important question is whether there exists a more economically sensible method of resolving the problem of structural polarization rather than through compensatory payments in the form of recurrent transfers.

While Flatters and Stern analysis of polarization completely misses the point because in almost all the BLNS the modest prosperity that has been achieved is unsustainable because it remains predicated on either the consumption or export of non-renewable mineral resources or the use of eroding preference arrangements for sugar beef, fish and garments into third country markets. Once these have disappeared then without diversification of the production base the modest prosperity of the BLNS will also disappear. This cannot be combated with recurrent revenue flows into the general revenue of the BLNS where increasing portions of national budgets are used on recurrent rather than development spending. In the final analysis only a coherent development and investment program backed by real and substantial resources can possibly combat the impacts of polarization.

4. SACU RSF Reform and Macroeconomic Stability in Southern Africa

Under pressure from the government of South Africa, SACU members initiated a review of the 2002 RSF[41]. A report was commissioned[42], reviewed and the recommendations largely rejected by its membership[43]. The determination of the revised formula has now shifted to political level. A regional committee was to report to ministers by September 2011. The proposals offered by CIE were based on the assumption countries would only be compensated on the basis of gross trade diversion effects. While the consultants did not address the issue of polarization in the calculation of compensation their conclusion, quite reasonably, was that it has to be addressed through development funds. The polarization effects on the BLNS are measured most appropriately by the trade imbalance between members based on intra-customs union trade[44]. The CIE study proposed a substantial reduction of payments to Botswana, Namibia and Swaziland and a commensurate increase to South Africa. The decreased compensation proposed implied a diminishing trade diversion effect on the BLNS because of the progressive liberalization of the SACU

CET. At no point in the analysis undertaken by the consultants is it clear that without a reform of the basis of the RSF to a destination principle would BLNS countries be willing to accept new members. Including either Angola and/or Mozambique in SACU would almost certainly mean a significant diluting of the share of revenue accruing to the BLNS under the current RSF. This is especially so of Mozambique which trades heavily with South Africa and very little externally.

In order to fully understand the magnitude of the fiscal adjustments required by member states if they are to move to a sustainable formula which facilitates broadening SACU, table 4 compares the projected customs revenue received in 2011/12 under various revenue sharing assumptions. In terms of analyzing the impact of the structural reform of the RSF that are required of the BLNS the shift from the revenues in column 2 with that of other formulae including that in column 5 where customs revenue distribution are based on share of external trade. It is thus an approximation of customs revenues derived under the destination principle. The second column in the table below shows actual amounts of customs revenue received and compares them to what would be received by the various formulas either used in SACU or in other customs unions. These include the share of population and GDP as well as the share of extra SACU trade. If South Africa were to abandon the SACU RSF and raise customs revenue itself thereby leaving the BLNS to collect their own customs revenue it would have approximately ZAR 19.5 billion more in tax revenue in 2011/12.

Table 4: Customs Revenue in 2011/12 under various RSF Assumptions (ZAR millions)

	2002 Formula	**Population (*Zollverein* Formula)**	**Share of GDP (excise rule)**	**Extra SACU Imports**	**Total Imports (1969 rule x 1.42)**
Botswana	9,720 (33.8)	931 (3.2)	1,036 (3.6)	141 (0.6)	1,534 (6.2)
Lesotho	3,122 (10.9)	959 (3.3)	164 (0.6)	127 (0.5)	656 (2.6)
Namibia	8,090 (28.1)	1,057 (3.7)	909 (3.2)	221 (0.9)	1,523 (6.1)
South Africa	4,513 (15.7)	25,217 (87.7)	26,356 (91.7)	24,001 (96.6)	20,197 (81.3)
Swaziland	3,295 (11.5)	577 (2.0)	277 (1.0)	348 (1.4)	929 (3.7)

Source: WTO, IMF World Economic Outlook Database April 2011, Central Intelligence Agency, IMF International Financial Statistics Yearbook, 2010 and authors' calculation. NB: Analysis for the 2002 Formula, Population and Share of GDP are based on the 2011/12 data, whereas analysis on the Extra SACU Imports and Total imports is based on the 2007/08 data due to the unavailability of more recent data on total imports and intra SACU imports, particularly to Lesotho and Swaziland. Values in parentheses are percentage share of total customs revenue

Table 5 considers what fiscal surpluses/deficits would be in all SACU members if the same SACU CET were applied to extra-SACU imports and divided on that basis ie the destination principle[45]. The table underestimates the amount of revenue that

countries would derive if individual BLNS levied their own tariffs but did not tax South Africa imports because clearly with more stringent rules of origin and greater border inspection more entrepot trade would be taxed. The BLNS would certainly capture far more entrepot and non-originating trade if revenue collection were on a destination basis at the final border. It is however a very broad indicator for the year 2007, an otherwise 'good year' from the point of fiscal balance when all SACU members ran surpluses. The figures in parentheses are the actual surplus or deficit in 2008. The third column presents the increase or decrease in revenue as a percentage of GDP that would result from a move to a formula based on a share of extra-SACU imports which is essentially the destination principle. The last column shows what the fiscal surplus or deficit would be in the event of such a change. What is significant is the 0.9% increase in South African GDP and no doubt the main reason for much of the discussion on the subject in South Africa. Needless to say the deficits for the BLNS, but Lesotho and Swaziland in particular, such a change in the SACU formula would be unsustainable and would necessitate substantial adjustments in all BLNS countries.

Table 5: Actual and Hypothetical Surpluses and Deficits for 2007 and (2008)

	Actual Surplus (Deficit)/GDP	**Loss of SACU Revenue/GDP**	**Hypothetical Surplus (Deficit)/GDP**
Botswana	5.6 (-3.8)	-9.2 (-8.4)	-3.6 (-12.2)
Lesotho	15.2 (4.0)	-26.7 (-30.1)	-11.5 (-26.1)
Namibia	3.9 (-3.6)	-7.8 (-9.3)	-3.9 (-12.9)
South Africa	0.8 (-0.6)	0.9 (1.0)	1.7 (0.4)
Swaziland	6.5 (-0.5)	-16.8 (-20.6)	-10.3 (-21.1)

Source: IMF, 2009, SACU Secretariat and authors' calculations NB: Values in parentheses shows the analysis for the year 2008

Botswana

The 2002 SACU RSF significantly increased the importance of SACU revenues to the government of Botswana (see chart 4). In combination with the decline in diamond revenues it SACU revenues rose to 29% of total government revenue in 2009. As diamond prices recovered in 2010 SACU revenues will once again become relatively less important. What is clear from table 6 is that in the absence of the current SACU revenue formula Botswana would need to raise a tariff equivalent significantly higher than the trade weighted average in order to achieve a revenue neutral shift. This would of course mean imposing a tariff on imports from South Africa and therefore exiting SADC. Such a hypothetical tariff would also have to be designed in such as way as not violate Botswana's bound rate obligations at the WTO.

Table 6: Effective and Nominal SACU Duties for Botswana

	Rate
Nominal Average SACU Tariff (2009)	8.1%
Trade Weighted Average (2008)	7.5%
Estimated Effective Rate of Customs Duty –Botswana (2009)[a/-]	19.7%

Source: WTO- Tariff Profiles and Trade Profiles, 2010, Bank of Botswana Annual Report, author's calculations, a/- calculated as the estimated customs revenue divided by total imports. Estimated customs duties are determined by applying ratios of customs to total SACU transfers.

What chart 1 depicts is the tariff equivalent for Botswana in the event that it chooses to replace a potential loss of tariff and excise revenue from SACU with an import duty. The chart shows that prior to both the 1969 and 2002 renegotiations the situation in Botswana had deteriorated to the point where the level of SACU revenues were approximately 7% of imports in the three years prior to 1969 and barely 10% of the imports by the time of the 2002 renegotiation. Indeed as chart 4, which provides us with a very long term view of the role of SACU revenue shows the importance of customs union revenue to Botswana had declined before 1910, 1969 and 2002.

The loss of revenue for Botswana in the event of a shift to a destination principle is approximately 8.4% of GDP in 2008. While substantial, if phased over a reasonable period it is achievable within the context of an orthodox adjustment regime as long as the timing of the decline does not coincide with the expected decline in revenues from diamond mining when the Jwaneng diamond mines goes into decline in at the current decade[46]. The issue of considerable concern is how the adjustment would occur. The general method proposed by the IMF but not necessarily accepted by the Government of Botswana is for the adjustment to be made through a downward reduction in wages and recurrent spending which would have significant effects on social stability while adjustment of development spending would fall more significantly on long term economic growth[47].

Namibia, Lesotho and Swaziland

For Botswana the macroeconomic aggregates and the economic base are such that adjustment to losses of recurrent revenue from SACU would require a very substantial but nonetheless possible fiscal adjustment if the adjustment period is of sufficient duration. The question of relevance is whether the other BLNS will be able adjust to the revenue losses implied by the shift from the status quo to a revenue sharing formula based on the destination principle (the shift from column 2 to column 5 in table 3). In 2009 Swaziland received 62.3% of its total revenue from SACU. In Lesotho the 2008 equivalent was 58.2%. (see chart 2). Few countries in the world have such a high level of dependence on one source of revenue that comes essentially as a flow from abroad.

The IMF has undertaken an analysis of Swaziland to address the fiscal adjustment required as a result of the cyclical downturn in revenue experienced in 2010/11 as a result of the decline in SACU revenues stemming from the 2008/9 global recession. The IMF analysis is based on the assumption of a 16% of GDP loss of SACU revenues for Swaziland with a 3 year adjustment. In the best case scenario, where the decline in SACU revenue is absorbed through a decline in recurrent spending, foresees a 10% decline in GDP over 20 years. If the decline in revenue is absorbed through decreased capital expenditure then the decrease in GDP over 20 years is 35-40%. Swaziland remains the most vulnerable of the BLNS. However these calculations are of a substantial but nonetheless cyclical decline in revenue that would be absorbed over three years. In calculations in table 3, and the subject of the current discussion, is based rather on a permanent and quantitatively more significant decline in revenue (21% of GDP in 2008) stemming from a shift to a destination principle.

Namibia, which has a significantly more diversified economy than any of the other BLNS states, has a rate of fiscal dependence on SACU of approximately 43% in 2009. Just as in the case of the other BLNS, the 2002 formula was instrumental in raising the rate of fiscal dependence on SACU. Namibia would be able to adjust to a permanent and greatly diminished flow of SACU revenues and remain solvent if its off-shore oil reserves come on stream.

The experience of countries facing the necessity of very large fiscal adjustments has been that the most successful cases have usually been large developed countries (see Tsibouris, *et al* 2006). In developing countries like Jamaica, Nigeria and Zambia a very large fiscal adjustment has not been sustained. Only South Africa (1993-2001) and Cote D'Ivoire (1993-200) are cited as having successfully sustained an adjustment. These are of course countries that are much larger and more resilient than Swaziland and Lesotho and hence a strategy that uses only fiscal adjustment in these cases is unlikely to be successful. It is for this reason that an alternative approach to orthodox adjustment is discussed below. It is noteworthy that in the database of 155 large fiscal adjustments documented by the IMF (Tsibouris, *et al,* 2006 p.27) a number of countries have experienced adjustments larger than that which would be experienced by Swaziland and Lesotho if they moved to the destination principle. However, the magnitude of the adjustment loss in GDP is lower but almost unprecedented in terms of the percentage loss of government revenue and almost none have economies with diversified revenue base.

Table 7 considers the various options for an orthodox fiscal adjustment which include increases in direct and indirect taxes and expenditure reduction programs for the two most vulnerable SACU economies. If Lesotho wished to use its personal taxes to compensate for a movement to the destination principle then direct revenue collections would have to increase by 327%. If the decrease in revenue were to

be dealt with by a decrease in government expenditure then the decrease would be 61.5% of 2008 expenditure. The order of magnitude of such a structural reform of expenditure and/or the tax base is such that an alternative integrated approach requires further consideration.

Table 7: Lesotho and Swaziland Experience with Fiscal Adjustment and Magnitude of Tax Increases/ Expenditure Reduction to Compensate for a Move to the Destination Principle

Country	Previous fiscal adjustment (% of GDP)	Adjustment to loss of SACU revenue (2008/9)	Revenue Neutral Income Tax	Revenue Neutral Sales/ Value Added Tax	Expenditure Reduction
Lesotho	18 (1988)	30.1%;(ZAR3.9 Bn)	327%	447%	61.5%
Swaziland	17.3 (1974);18.1 (1979);9.2 (1987)	20.6% ;(ZAR 4.8 Bn)	402%	490%	49.3%

Source: Tsibouris, et al 2006, IMF International Financial Statistics Yearbook, 2010, SACU Secretariat, Central Bank of Swaziland, 2010, Lesotho Bureau of Statistics, 2009, and authors' calculation.

South Africa

South African concerns with regard to the RSF need to be understood as its officials who have negotiated the SADC FTA and are currently negotiating the tripartite agreement (SADC-EAC-COMESA) no longer feel the need for such compensatory payments in order to assure adequate market access for South African exports into SACU countries. Such considerations it s argued are a part of the apartheid era and SADC FTA is now legally implemented rendering other market access arrangements as irrelevant. Instead the inequity of RSF, where South Africa accounts for 92% of SACU GDP and claims 46% of customs revenue is seen as in need of redress. Table 8 shows the declining share of total SACU revenue derived by South Africa. While the increase in revenue for South Africa stemming from a movement to the destination principle is potentially significant and would alleviate this perception of inequity of the current fiscal arrangement it would have little percentage impact on the GDP while running the considerable risk that the adjustment of Swaziland and Lesotho would be unsuccessful and result in political instability on South Africa's borders. Given the very negative spillover effects on South Africa of political and economic instability in Zimbabwe the very cautious approach to RSF reform in Pretoria is understandable.

Table 8: Share of Total SACU Revenue Pool to BLS/BLNS

	Share of the BLS/BLNS
1968/9	1.32%
1983/4	20.5%
1993/4	30.2%
1997/8	38.4%
2002/3	42%
2005/6 (post 2002)	50.02%
2011/12(forecast)	54.2%

Source: McCarthy C. (2006); Flatters and Stern (2006); CIE (2011)

5. RSF Reform – A Developmental SACU

Assuming that the objectives of the membership can be judged by the SACU Vision some direction can be provided in terms of viewing the need for RSF reform. The members of SACU aim that that the organization be 'an economic community with equitable and sustainable development, dedicated to the welfare of its people for a common future'. However, the current SACU RSF are perceived as inequitable by all its members as the BLNS require compensation to remain members, and South Africa perceives its current share of customs revenue as inadequate given its relative size in the customs union. The perceived inequity of the SACU arrangement from the perspective of the BLNS stems from the polarization effects which has resulted in the agglomeration of virtually all production in South Africa. More importantly is the fact the current development path of SACU members in unsustainable as it is predicated, to a greater or lesser degree, on the export of unprocessed products of extractive industries.

The mission statement of SACU says, inter alia that SACU is 'to serve as a building block of an ever closer community among the peoples of Southern Africa'. As outlined above, rather than being a building block of southern African integration the current RSF is one of the main stumbling blocks to that integration. The economic polarization and the perception of capture of virtually all production benefits of SACU by South Africa has been an important factor in diminishing the will of SADC members to remove non-tariff barriers to trade.

There is nothing in the current RSF that provides economic benefits in a form that would result in parties financing strategies to address the economic polarization that has emerged over a century of integration. Simply put, revenue transfers to the general revenue from South Africa to the BLNS have not changed the fundamental reasons for those transfers, i.e. polarization of economic activity. Three different types of expenditure may affect polarization:

1. Substantial and sustained investment and development expenditure by government,
2. Resources and infrastructure, appropriately priced, to attract investors to locate in peripheral regions,
3. An effective and well funded national and regional industrial policy.

There can be no guarantee of success in addressing economic polarization in the medium term. This has only been reversed over the very long run (see Krugman and Venables, 1995) and will in the context of SACU require several decades of concerted and effective intervention. However, the current approach of providing compensatory transfers to the general revenue which has existed since the 1969 Agreement has not addressed the reasons why compensatory transfers were needed and has only created an unsustainable fiscal context in the BLNS.

In accordance with the Vision and Missions and assuming that SACU members wish development to be a basis for integration and address the issue of a sustainable and equitable policy for members that the following proposal is made. The only formula that would permit the expansion of SACU and the deepening of SADC into a customs union i.e. the destination principle at the same time would, as seen in the previous section, result in a fiscal contraction in the BLNS which would be unparalleled in magnitude in the post-independence history of those countries. Simultaneously this would result in a massive windfall that would, under current arrangements, be distributed to South Africa in increased general revenue, by as much as ZAR 19 billion.

This windfall should at first be used on a decreasing annual basis to assist members to cushion the fiscal adjustment to the destination principle over a period of seven to ten years. The balance between the windfall and the diminishing adjustment payments should be used to create a fund to finance industrial policy and development projects in all the SACU states. The reason for such an approach can be seen in chart 5 where public investment as a percentage of GDP has been either stagnant or declining over two decades in all SACU countries. The discipline of earmarking SACU revenues for development projects rather than general revenue can, over the long term provide the revenue for reversing polarization.

A variable geometry of macroeconomic adjustment

In order to address this issue of macroeconomic adjustment to new formula based on a variable geometry is needed and a clear differentiation between the cases of Botswana and Namibia, on the one hand, which are relatively resilient and prosperous economies, and that of Swaziland and Lesotho on the other which are smaller and more vulnerable and hence far less able to successfully adjust to such significant reforms through the normal structural adjustment process. For Lesotho

and Swaziland the level of dependence on SACU as seen above is such that, in line with all other previous reforms of the RSF, a new political accommodation between those two countries and South Africa is a necessary pre-condition to RSF reform because the loss of revenues from a move to a sustainable destination principle in SACU would be of such an order of magnitude as to destabilize both countries and likely leave them as failed states. Even over a protracted period of adjustment as suggested in the CIE report, a 50%- 60% decline in government revenues, where government remains the leading sector would lead to long term economic stagnation.

A new political and economic dispensation for Lesotho and Swaziland would almost certainly be part of integration into a common market and have to include a relatively free movement of labour into RSA, which already exists under sector specific quota from Lesotho. This would act as one of the main trade mechanisms that would cushion the shock of so precipitous a long term decline in revenue. Should long term revenue flows from South Africa to Swaziland and Lesotho also be required as part of the adjustment package this may well require an even greater deepening of the economic and political relationship which is beyond the scope of this paper.

Botswana and Namibia with their relatively modest rates of dependence on SACU transfers can, over a period of a decade, undertake a structural adjustment without it being preconditioned by a new political dispensation. This is not to suggest that the creation of a common market and deeper integration including Namibia and Botswana i.e. all SACU members is not desirable but rather that it is not a precondition to a feasible macroeconomic reform. Both countries posses either a sufficiently wealthy or diversified economies and hence an orthodox structural adjustment of the revenues is conceivable.

Any reform of the RSF will take a minimum of a decade to implement for all SACU members so a phased implementation of movement away from general revenue transfers to a more constructive and developmental approach cannot occur immediately. After an appropriate period an RSF which devotes most of the revenue from SACU customs to development expenditure at the national and regional remains the only way in which polarization can be addressed. Providing improved national infrastructure, allowing BLNS to provide incentives to investors' equivalent to that of RSA, and regional trade and industrial policy measures should logically become part of the deployment of the movement away from using SACU revenues as general revenue.

The traditional response to any proposal for using SACU revenues for a development fund has been met with a general response by the BLNS that their national governments, rather than a supra national body or, in the worst case scenario, South Africa are the most appropriate authorities to decide how public resources are used. In part this

response stems from a belief that these revenues, channeled in such a way would in effect become South African aid funds, donated by Pretoria and used at its discretion. However, assuming that investment of SACU resource for the development of the member countries is the objective of all SACU members then the evidence suggests that all SACU governments have devoted a decreasing or at least stagnant share of national resources to public investment (see chart 5). Indeed a discipline that foresees the use of these SACU resources for national and regional development projects, and trade and investment facilitation may facilitate the reversal of both the expenditure and polarization trends observed. However, in the final analysis the economic forces of agglomeration may be such that SACU members will be unable to reverse this trend but what is certain is that over 40 years of compensation payments to the BLNS have not served this purpose. A fund, properly administered, and devoted to national and regional development projects and allowing the BLNS to provide comparable levels of support provided to industry by South Africa may achieve this objective.

6. Conclusion

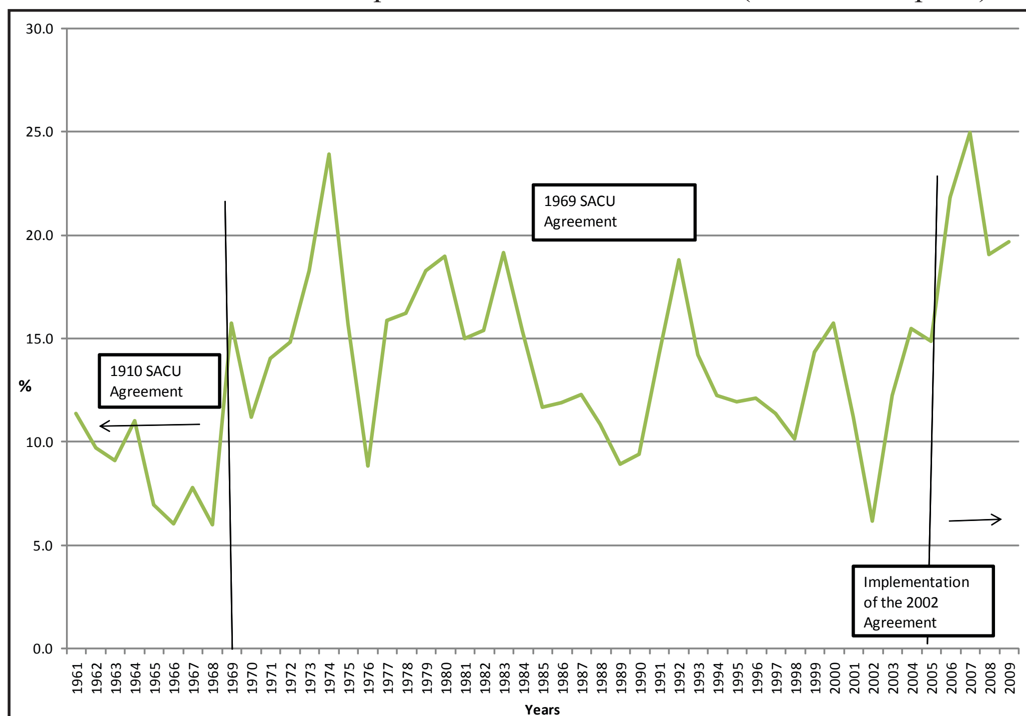
From 1910 until 1969 a variant of the destination principle was used to determine allocation of SACU revenues. With independence of the BLS the apartheid regime created a new formula that served to increase the share of the BLS and made South Africa a residual claimant on SACU customs revenue. The 2002 reforms removed this anomaly but at the same time increased the share that accrued to the BLNS. This in turn has meant that the share accruing to South Africa has diminished over time. The 2002 formula based on a share of intra-SACU imports remains like its predecessor, a compensation for polarization and price raising effects of the customs union. However, to compensate for a structural phenomenon such as production polarization in a customs union by general revenue transfers to the effected party has not proven to be a solution to the underlying problem and has created unsustainable levels of public consumption. If it is the intention of members to fulfill the SACU Vision then delivering SACU revenue as national and regional development projects rather than transfers to the general revenue is more likely to positively impact on the development of the BLNS than the current arrangements and should, subject to appropriate dispersal arrangements, be supported.

The removal of SACU transfers from general revenue of the BLNS would necessitate a severe fiscal adjustment, even for Botswana with its considerable diamond resources, but it would, without a renegotiated fiscal relationship, be very unlikely to succeed for two small low income economies such as Swaziland and Lesotho. Namibia could achieve a change in its tax base once it’s very substantial discoveries of oil come on stream. South Africa will have to consider appropriate fiscal, trade and possibly political arrangements for Swaziland and Lesotho as it is difficult to foresee how either of these smaller and more vulnerable SACU members could make

the adjustment to a sustainable revenue sharing formula without serious political instability. Therefore like all previous adjustments to the SACU RSF this change will also need to be preceded by a shift in the political arrangements in southern Africa. The move to development fund, as proposed in this paper, as opposed to transfers to general revenue will have to be carefully phased over a sufficiently lengthy period to allow Botswana and Namibia to adjust.

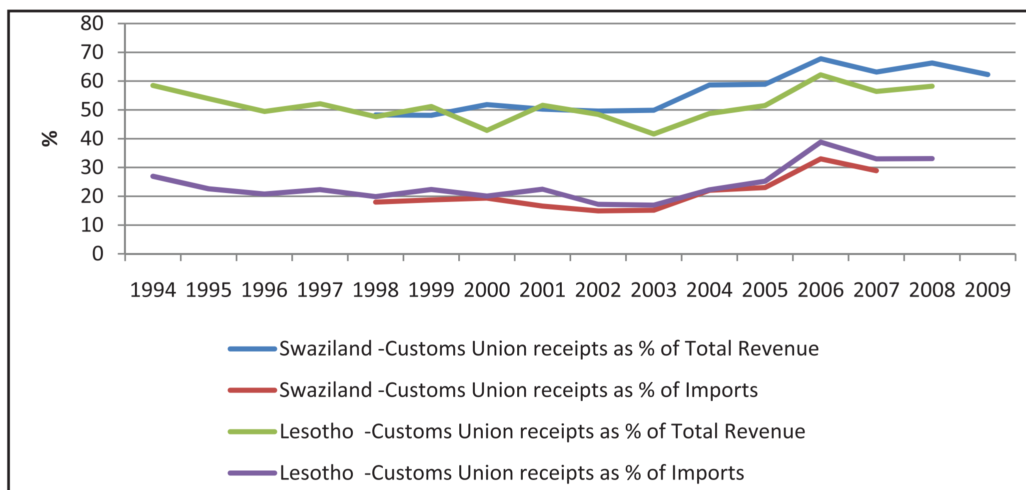
The South African government is keenly aware that within its domestic context dealing with the inequity created by apartheid must be seen as generational effort. The revenue dependence created by the 1969 SACU formula must also be seen in this time horizon; as an apartheid era distortion that will take a generation to fully and properly address. If South Africa does not move patiently and prudently with any proposed reforms then it runs the risk of not only destabilizing SACU but also creating at least two fiscally insolvent states in and on its borders.

Chart 1: Botswana Tariff Equivalent of SACU Revenue (Customs /Imports)



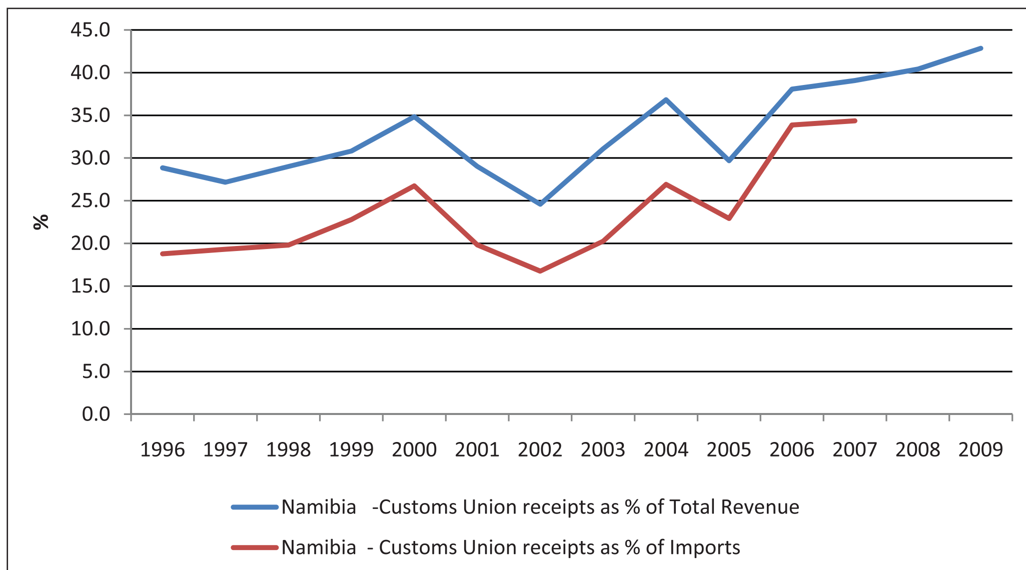
Source: CSO and author's calculation

Chart 2: SACU Receipts /Imports and SACU Receipts/ Total Revenue for Swaziland and Lesotho



Source: IMF IFS statistics, Respective Central Bank data and author's estimates

Chart 3: SACU Receipts /Imports and SACU Receipts/ Total Revenue for Namibia



Source: Namibia Central Bureau of Statistics and Author's calculations.

Chart 4: SACU and pre-SACU Revenues as a Percentage of Total Botswana Government Revenue

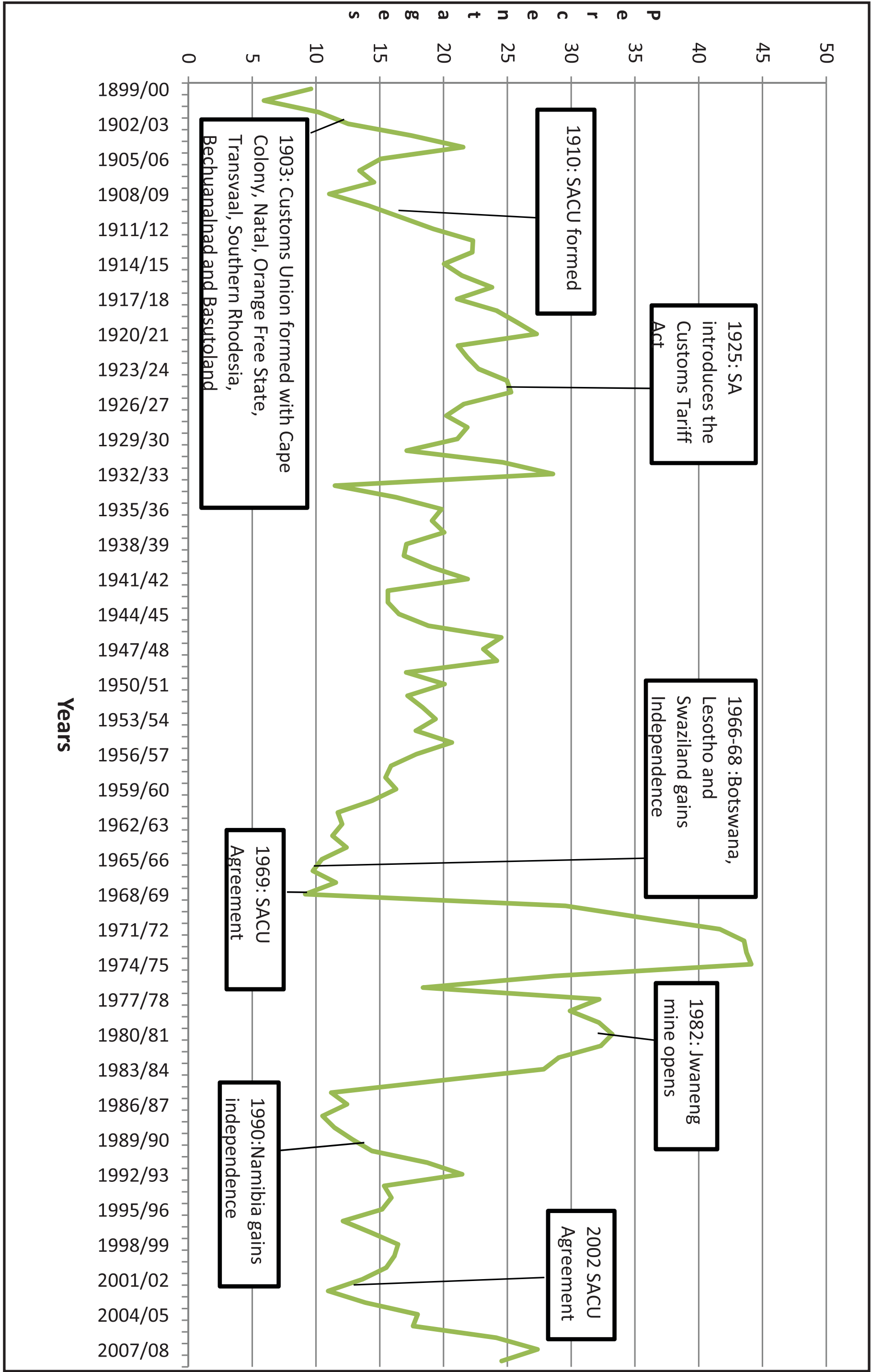
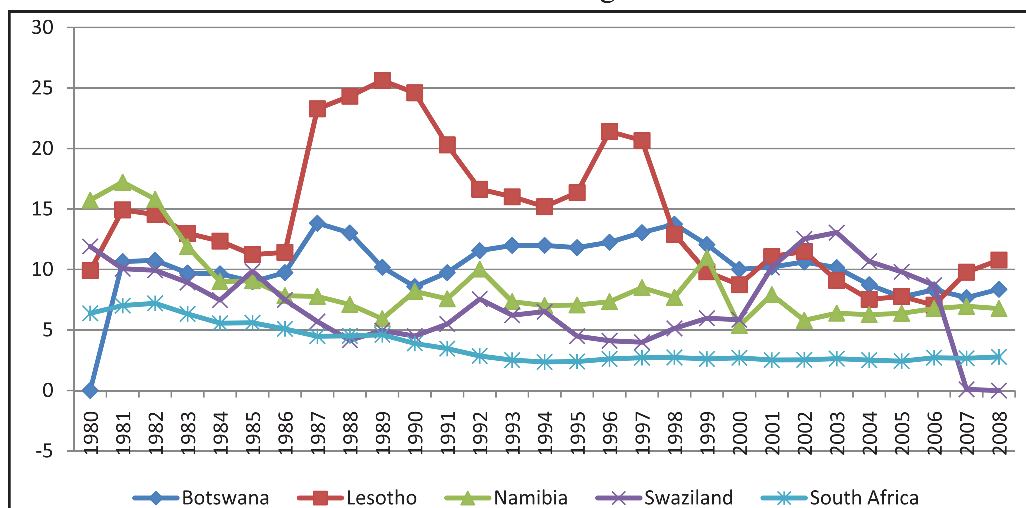


Chart 5: Gross Public Investment as Percentage of GDP in SACU Countries



Source: African Development Indicators, World Bank 2010.

Table 9: Structure of SACU trade: Exports, 2008 and 2009

Country	Total (Billon rands)	3 largest (top) commodity	% of total exports to GDP
Botswana	27.8	1. Pearls, precious stones, metals, coins, etc 2. Nickel and articles thereof 3. Articles of apparel, accessories, not knit or crochet	28.7
Lesotho	5.9	1. Articles of apparel, accessories, knit or crochet 2. Articles of apparel, accessories, not knit or crochet 3. Electrical, electronic equipment	44.6
Namibia	32.6	1. Pearls, precious stones, metals, coins, etc 2. Ores, slag and ash 3. Fish, crustaceans, mollusks, aquatic invertebrates nes	44
South Africa	585	1. Pearls, precious stones, metals, coins, etc 2. Mineral fuels, oils, distillation products, etc 3. Vehicles other than railway, tramway	25.7
Swaziland	10.3	1. Essential oils, perfumes, cosmetics, toiletries 2. Miscellaneous chemical products 3. Sugars and sugar confectionery	44

NB: "Values for Lesotho and Swaziland are for the year 2008 whereas values for Botswana, Namibia and South Africa are for the year 2009. Source: SACU, 2009 and IMF International Financial Statistics Yearbook, 2010"

Table 10: Structure of Total SACU trade: Imports, 2008 and 2009

Country	Total (Billon rands)	3 largest (top) commodity	% of total imports to GDP
Botswana	37.3	1. Mineral fuels, oils, distillation products, etc 2. Machinery and mechanical appliances; parts thereof 3. Vehicles other than railway, tramway	35.8
Lesotho	8.4	1. Minerals fuels, oils, distillation products, etc 2. Vehicles other than railway, tramway 3. Electrical, electronic equipment	63.5
Namibia	41.2	1. Vehicles other than railway or tramway 2. Machinery and mechanical appliances; parts thereof 3. Electrical, electronic equipment	55.7
South Africa	552.9	1. Mineral fuels, oils, distillation products, etc 2. Machinery and mechanical appliances; parts thereof 3. Electrical, electronic equipment	24.3
Swaziland	9.0	1. Minerals fuels, oils, distillation products, etc 2. Machinery and machinery appliances; parts thereof 3. Vehicles other than railway and parts and accessories thereof	38.4

NB: Values for Lesotho and Swaziland are for the year 2008 whereas values for Botswana, Namibia and South Africa are for the year 2009. Source: SACU, 2009 and IMF International Financial Statistics Yearbook, 2010

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END NOTES

[1] For a thorough coverage of terms of SACU see R.Kirk & Stern M. 'The New Southern African Customs Union Agreement' *The World Economy*, Vol. 28, No. 2, pp. 169-190, February 2005; McCarthy C. 'The Southern African Customs Union: A Case Study' FAO, Rome 2003

[2] In 1990 Namibia became independent and in 2002 acceded to SACU.

[3] The Tati Concession did not initially participate in the customs union but joined in 1898. This historical section draws heavily on the work of Hudson D Botswana's membership of the SACU in Harvey C 'Papers on the Economy of Botswana', Heinemann, 1981.

[4] The common external tariff was 10% and set at 7.5% for British imports. This was raised to 15% and 12% respectively in 1906. Swaziland joined later on.

[5] The position that was maintained by Britain until the election of the Nationalists in South Africa I 1948 and the exit of South Africa from the Commonwealth in 1961.

[6] See Ettinger, S. 'The Bechuanaland Protectorate's participation in pre-1910 Customs Unions' in *Botswana Notes and Records*, 1975 Volume 7, pp 49-52 South Africa did have representative government but the three protectorates did not participate in the discussions. Their membership stemmed from the British colonial office position that they would eventually become part of the Union of South Africa. For original text see British High Commissioner's Notice 65 of 29 June I9I0, Customs Agreement: Union of South Africa - Territories of Basutoland, Swaziland, and the Bechuanaland Protectorate

[7] The Southern Africa Customs Union of 1910, No. 274 23rd July 1910. Even this first treaty gave some room for the territories to have tariff regimes that were at variance with that of South Africa. The preamble states that :

a) The territories shall maintain a tariff similar to that which exists in the Union Of South Africa;
b) An equitable share of the duties collected on goods passing through the Union to the Territories shall be paid over to them, and vice versa;
c) There should be a free interchange of South African products and manufactures between the Union and the Territories
http://www.sacu.int/main.php?include=docs/legislation/1910-agreement.html,

[8] The Potchefstroom Formula was based on the share of duty on the goods consumed in each country during the period April 1907-March 1910. The revenue arrangement was based not only on customs duty but also on excise.
[9] See Hudson op.cit p132

[10] See Landell -Mills P.M 'The 1969 Southern African Customs Union Agreement, *The Journal of Modern African Studies*, 9, 2, (I971), pp. 263-81 held the common view at the time of the development of the new arrangement 'the fact that for 30 years the residents B.L.S. had been subsidizing South African industrial development, nurtured behind high protective tariff..' Pp.266.

[11] Report of the Ministry of Overseas Development 'The Development of the Bechuanaland Economy' November 1965, Published by the Government of the Republic of Botswana, Gaborone, p. 11

> The available evidence suggests that under this arrangement (the SACU formula) the revenues from this source are not less than she (Botswana) would raise if she had her own customs administration levying the same rates of duty. Bechuanaland is therefore spared the burden of administering her own customs and excise system.... Over the last ten years revenues from this source have steadily increased; and it cannot be said that the government has done badly from the arrangement.

[12] Transitional Development Plan, Government of Botswana, 1966,

> The Customs Agreement, whilst relieving Botswana of the burden of costly customs administration, means that the increase in revenue accruing to the Exchequer from this source is not related to the growth in economic activity within the country. The actual tariffs levied are determined by South African interests. High protective duties imposed to protect South African industry tend to diminish the total revenue collected and therefore that part accruing to the Botswana Exchequer. In such cases the diversion of consumers from cheaper overseas imports to more expensive South African manufactures results in a transfer of spending power from Botswana consumers to South African producers or, in other words, the subsidization of South African industry by Botswana. A Customs Union between a rich and a poor nation normally produces a polarity of economic development, with the better endowed areas growing at the expense of the poor areas. In recognition of this process, it is necessary to make some provision for the automatic redistribution of resources towards the poorer partner. The Botswana Government will therefore seek to negotiate with the Government of the Republic of South Africa a more equitable customs arrangement. (emphasis added)

[13] http://www.sacu.int/main.php?include=docs/legislation/1969-agreement/main.html, see also Republic of South Africa, 1969. "Customs Union Agreement between the Governments of the Republic of South Africa, the Republic of Botswana, the Kingdom of Lesotho and the Kingdom of Swaziland", *Government Gazette*, vol. 54(2584)

[14] The revenue sharing equation can be presented in the following manner

$$R_i = \frac{(M_i + P_i)}{\sum_{i=1}^{4}(M_i + P_i)} \times \{\sum_{i=1}^{4}(C_i + E_i + S_i)\} \times 1.42$$

Where $R_{sa} = \{\sum_{i=1}^{n}(R_i + E_i + S_i)\} - \sum_{i=1}^{a} R_i$

R_i = Revenue of country i (Botswana Lesotho and Swaziland)
R_{sa} = South African revenue from SACU
M_i = CIF Imports of country i
P_i = Value of dutiable goods produced i (Botswana, Lesotho and Swaziland)

$\{\sum_{i=1}^{4}(C_i + E_i + S_i)\}$ = sum of customs, excise and sales tax revenue in the customs area

This in turn created the possibility that if :

$$\sum_{i=1}^{a} R_i > \sum_{i=1}^{4} (C_i + E_i + S_i)$$

Or $R_{sa} < 0$

[15] See Gibb (1997:p 78), Lundahl (1991), Mayer and Zurendra (1994, p.36)

[16] de Melo, et al found the the BLS benefited for the SACU agreement as a whole. Analyzing a number of trade agreements they found that there was no evidence that regional integration among developing countries exerted a positive effect on income and growth, except in the case of the Southern African Customs Union (SACU) where favorable growth effects were found for Botswana, Lesotho and Swaziland. The authors suggested several channels through which regional integration could alter economic outcomes for the better. One of the important avenues is that regional trade agreement results in a larger political community which might lessen the scope for adverse discretionary actions by governments, and in particular restrict the power of growth-retarding political interest groups, unless politically powerful lobbies can form alliances across countries. In the case of SACU where all decisions were made by South Africa in its own commercial interests in the period under study this says a great deal about the potentially adverse impact that trade policy in small developing countries can have on growth. de Melo, pp.158-193, See footnote 29, page 190

[17] BLS countries have actively pursued protectionist policies within the context of their own markets. These have given rise to many small sub-economic sectors. See for example Grynberg R and Motswapong M. Competition Policy and Import Substitution: The Case of the Botswana Poultry Industry, BIDPA Working Paper 2011.

[18] The then vice-president Masire who was very closely involved in the negotiations clearly saw the 1.42 as a 'compensation factor to recognize polarization effects and the price raising effect of protective tariffs on goods we bought from South Africa' see Q.K.J Masire ' Very Brave or Very Foolish –Memoirs of an African Democrat' MacMillan, Gaborone 2006 page 258. See also Landell-Mills, op.cit, page 275

[19] Former President Masire argued that 'Because our arguments were sound, and perhaps as a kind of good neighborliness, South Africa agreed to particular aspects of the revenue sharing formula we proposed' ibid

[20] Evaluation of an Appropriate Model for a SADC Customs Union' Final Report Commissioned by The SADC Secretariat, 3 September 2007, see page 56-57

[21] An Overview of the SACU from Botswana's perspective: Implications of the Historical record and Contemporary Situation for Renegotiation of the Arrangement' Ministry of Finance and Development Planning. *The Research Bulletin*, Bank of Botswana, September 1994, pp13-32, see page 15. It should be noted that the author of the paper, the acting Permanent Secretary, Mr John Stoneham stated that this was not necessarily the official position of the government of Botswana. Given the status of the author and its subsequent publication in the Bank of Botswana research bulletin the caveat can be disregarded and the document can be treated as one close to the official government position as is publicly available.

[22] 'The Development of the Bechuanaland Economy' November 1965, op cit., page 88

[23] Botswana: Development Strategy in a Mineral led Economy- Basic report volume 1, May 1975, report No. 735-BT , table 5.1 statistical annex

[24] Hudson D. 'Botswana's Membership of the Southern African Customs Union' in Harvey C. Papers on the Economy of Botswana, Heinemann (London) 1981 p. 146. Hudson was at the time head of research at the Bank of Botswana. It should also be noted that Hudson was writing at a time when there had been major mining developments which caused a surge in imports thus increasing the return to the country. Hudson concluded:

> The gross benefit to Botswana of the 1.42 multiplier is probably around Pula 30 million a year at present. It is a matter of debate whether the net benefit to Botswana of leaving the Customs Union could ever equal such a large sum. Even if we leave that aside , we note that Botswana would have to charge about 16% on the value of imports and local dutiable production in order to recover just the tax element of the present revenue flow.

[25] The new stabilization factor created a new condition for revenue sharing:

$$17\% \geq \frac{\mathrm{R_i}}{\mathrm{Mi + Pi}} \leq 23\% \approx 20\%$$

[6] An Overview of the SACU from Botswana's perspective: Implications of the Historical record and Contemporary Situation for Renegotiation of the Arrangement' op cit p22 '...the government of South Africa created 'independent states' beginning in the late 1970's , it reportedly made agreements parallel to the SACU agreement and began paying shares to four of these entities from the SACU Revenue pool'

[27] The three components can be written as follows:

$$R_i = \sum(C_i + E_i + D_i)$$

$$C_i = \frac{M_i^{int}}{\sum_{i=1}^{5} M_i^{int}} \times C$$ ....Customs Component

$$E_i = \frac{GDP_i}{\sum_{i=1}^{5} GDP_i} \times E$$..Excise Component

$$D_i = \left[1 - \left\{\frac{GDP_i}{\sum_{i=1}^{5} GDPi/5}\right\}/10\right] * {}^{D}/_{5} \text{........................Development Component}$$

Where R_i = Revenue of Country i from the customs union
C_i = Customs revenue derived by country i
E_i= Excise derived by country i
D_i= Development revenue of country i
GDP_i= GDP of country i
M_i^{int} = Intra SACU imports of country i
E = Total Excise Pool (minus development)
C = Total external customs pool
D = development pool

[28] The new revenue-sharing formula and the Common Revenue Pool is governed by Articles 32 to 37, and Annex A of the 2002 SACU Agreement. Under Article 32, all customs, excise, and additional duties collected in the common customs area are to be paid into the common revenue pool, within three months of the end of each quarter of a financial year.
[29] Section 93 of the Australian Constitution states that: 'During the first five years after the imposition of uniform duties of customs, and thereafter until the Parliament otherwise provides:(i) the duties of customs chargeable on goods imported into a State and afterwards passing into another State for consumption, and the duties of excise paid on goods produced or manufactured in a State and afterwards passing into another State for consumption, shall be taken to have been collected not in the former but in the latter.

[30] SADC 'Evaluation of an Appropriate Model for a Customs Union – Final Report', September 2007, pp. 57-58

[31] In Viner (1950)'s classic work on customs unions from 1950 he summarized the difficulties that confront the distribution of revenue in a customs union with such disparate members. His words continue to resonate throughout a century of often acrimonious disagreement over revenue sharing in SACU:
...the greater the disparity in economic levels between the members, and the greater the differences as between the members in the customary consumption of imported commodities, the greater is likely to be the difficulty in finding a formula for allocation of customs receipts which will be mutually acceptable.

[32] This can be presented as:
$$R_i = \sum_{j=1}^{n} t_j \, M_{ij}$$

Where R_i= Total Import Duty Revenue of Country i in the customs union
t_j = common external tariff on product j
M_{ij} = imports into country i of product j from outside the customs union

In reality though the formula is generalizable, as in the case of SACU and some countries in UEMOA where transfer payment are made. Therefore the generalised equation should be:

$$R_i = \sum_{j=1}^{n} t_j M_{ij} + T_i$$

T_i = Transfer to country i from other members of the customs union

[33] As long as any border tariff in any member of the customs union e.g. Botswana were less that the decrease in costs from bulk purchase the entrepot trade would continue irrespective of the trade regime in place between members of the customs union.

[34] SACU does have a complex rule of origin See Schedule 1, Part 1 SACU 2002.

[35] Thus in order to obtain the total benefit of customs union membership equation above must be modified to include the net external benefits to each member which produces

$$\mathrm{NB_i} = \mathrm{R_i} + \sum_{k=1}^{8} \mathrm{E_{ik}}$$

$$\mathrm{NB_i} = \sum_{j=1}^{n} \mathrm{t_j\, M_i} + \mathrm{T_i} + \sum_{k=1}^{8} \mathrm{E_{ik}}$$

Where $\sum_{i=1}^{8} \mathrm{E_{ik}} = \sum_{i=1}^{n} (\mathrm{NTC_i} + \Delta\mathrm{TC_i} + \Delta\mathrm{C_i})$

Where R_i = government revenue for country i from the customs union

$\sum_{i=1}^{8} \mathrm{E_{ik}}$ = sum of e external benefits for country i

NTC_i = Net trade creation effects = trade creation minus trade diversion

ΔC_i = change in cost of producing in country i

ΔTC_i = change in transaction costs of trade from customs union for country i

The stability condition for the customs union is:

$$\sum_{\substack{i=1,\\ k=1}}^{e,n} E_{ik} > 0 \; and \; if \; T_i > 0 \rightarrow T_i \geq \left| \sum_{k=1}^{8} E_{ik} \right| \quad if \; T_i < 0 \rightarrow |T_i| \leq \sum_{k=1}^{8} E_{ik}$$

[36] Leith found that SACU RSF had resulted in decreases GDP/capita in Botswana.

[37] SADC FTA – Article 3. By January 2008 85% of HS tariff lines were duty free. 'Guide to the SADC protocol on Trade' SADC Secretariat -2008. 15% of tariff lines leave considerable room for member states to maintain some tariffs against imports from other contracting partners. Moreover, despite 'commitments' made to implement by 2008 many countries have not yet fulfilled their commitments under the trade protocol.

[38] The average SACU binding is approximately 8.6% though each member of SACU made separate MFN binding during the Uruguay Round. Lesotho's bindings are much higher than that of the rest of SACU.

[39] World Bank (2009) 'World Development Report –Reshaping Economic Geography' Washington

[40] In the case of Botswana diamond exports and prices together explain 91% of GDP per capita over the last 30 years. This also reflects relatively good governance in Botswana because, if the data existed, a similar regression analysis for DRC, Angola or Sierra Leone would be very unlikely to explain GDP per capita.

[41] "The South Africans have formally proposed a change in the revenue sharing formula, which is discussed as part of a blueprint to overhaul the customs union," confirmed Kuukongelwa-Amadhila's permanent secretary Calle Schlettwein, who is in charge of the SACU working group tasked with this matter. It seems South Africa wants a system that instructs the BLNS countries to submit development plans that will be financed through the pool, instead of the union bankrolling national budgets. Source Tralac
http://www.tralac.org/cgi-bin/giga.cgi?cmd=cause_dir_news_item&cause_id=1694&news_id=84137&cat_id=1026

[42] See Centre for International Economics (for SACU Secretariat) 'Study on the Review of the Revenue Sharing Arrangement for SACU', March 2011, Canberra
[43] It is the understanding of the authors that the SACU members have never approved any of the studies that they have commissioned.

[44] The data on polarization of trade and economic activity in SACU with the resulting structural imbalances is unambiguous. The BLNS produce largely raw materials for export to SA and import a wide range of agricultural, manufactured and intermediate goods as the most recent intra-SACU trade data suggest. According to the SACU Secretariat, 2009, a large share of Botswana's intra-SACU imports originate from South Africa (99.1% in 2009) and Intra-SACU imports accounted for about 81.1% of the total imports of Botswana in 2009. For Lesotho, intra-SACU imports accounted for about 95.3% of total imports to Lesotho in 2008, with South Africa accounting for about 99.7% of intra-SACU imports. Namibia's intra-SACU imports accounted for about 70.1% of its total imports in 2009 and a large share, of about 99.1% of intra-SACU imports originated from South Africa. However, only 2% of total South African imports came from SACU, 67% of this figure originated from Swaziland and Namibia. These imports include sugar and sugar confectionery; beverages, spirits and vinegars; essential oil, perfumes, and cosmetics; and electrical, electronic equipments.

[45] This over-estimates the revenue losses to the BLNS because a significant portion of what is deemed as South African imports is improperly classified due to entrepot trade and is a re-export of 3rd country products.

[46] See National Development Plan 10,

[47] See IMF 2011, ibid page 2

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