Development Policy Research Unit
University of Cape Town

What are the potential benefits and pitfalls of a free trade area in the Southern African region

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Introduction

Integration can take many forms and as such, the question necessarily arises; is a free trade area the ideal mechanism for the southern African region? Even if it is the ideal mechanism in a theoretical sense, is the Southern African Development Community (SADC) Free Trade Area (FTA) likely to succeed in the regions' current economic environment?

This policy brief considers the merits and pitfalls of a free trade agreement for the southern African region.

The costs and benefits of implementing the FTA for the major SADC countries

Trade creation versus trade diversion

FTAs appear to be superior to Custom Unions (CUs). FTAs succeed in creating trade but the extent of trade that is diverted is far less.

While CUs generally succeed in creating trade, they also divert it from low cost suppliers outside of the region, to higher cost suppliers within the region.

The dynamic gains from an FTA

Larger markets create cost savings

Because both an FTA and a CU effectively create a larger market, economies of scale facilitate lower tariffs than would be feasible in a smaller, non-integrated system.

Not only could the common external tariff be lower than the original tariff in partner countries but, in the case of an FTA, individual country post-integration tariffs would be lower than the pre-integration tariffs in those countries.

Larger markets attract FDI

The larger market is also more likely to attract foreign investment (FDI), not only because of its desirability as a consumer base but also because the regional integration structure would make it more cost effective to produce and sell from within the region than from outside of the region.

Gains from trade diversion

When trade is diverted, the world price of a good will drop (assuming that supply is not infinitely elastic). This moves the terms of trade in favour of the FTA or CU, creating a welfare gain that may partially (if not totally) offset the welfare loss of the initial trade diversion.

Can an FTA promote policy credibility?

A regional integration agreement such as a free trade area may promote policy credibility for the following reasons:

- It "**locks in" trade reforms**
- It entails a **larger political community** that lessens the scope for discretionary government action and reduces the power of special interest groups
- It is assumed that **better information** would be available at a multi-national level than at a nation-state level, thus improving decision making capabilities
- Entering into this form of agreement in the first place requires sunk costs and **sends a signal that the government is committed to liberal reforms**

Can a FTA boost investment in the region?

An increased return on capital relative to risk increases the likelihood of investment. An FTA *will* raise the returns to at least some factors of production by facilitating less costly trade in terms of both time and money invested.

However, in an FTA where regional integration affects only tariffs, the benefits of these increased returns are often offset by higher taxes – and hence decreased returns – to other factors. If one assumes then that the cost of capital remains constant, the economy responds with increased rates of return, therefore capital stock increases, and one is likely to see a temporary acceleration of growth rates. This higher growth trajectory will result in higher output per head but growth will, in time, return to its original level.

Reasons why an FTA may raise the return on capital regardless of the original capital base are that an FTA may:

- **stimulate demand for capital relative to labour** - an FTA reduces transaction costs on tradable goods (which are typically capital-intensive) relative to non-tradable goods (which are relatively labour intensive).
- **reduce the cost of imported capital equipment** or, by opening up the financial sector, **reduce the cost of financial capital**
- **reduce uncertainty** and **increase the credibility** of the government's ability to pursue sound and predictable policies

It is important to note that a free trade agreement such as the SADC FTA may initially reduce FDI from within the region, as trade becomes a more attractive option than investment. However, foreign investment from outside of the trading bloc is likely to increase for reasons outlined previously.

How will regional integration affect optimal industrial location in SADC?

Agglomeration benefits accrue to clusters of firms in close geographical proximity. As one firm relocates, it creates an incentive for other firms to relocate, and as industry relocates, agriculture adjusts by releasing or absorbing labour and thus maintaining an external balance.

There is concern in SADC that the concentration of existing industry in the Southern African Customs Union (SACU) region, and in South Africa particularly, will mean that free trade creates the opportunity for industry to gather in these countries only – to the detriment of their smaller neighbors.

Industries with increasing returns are already generally based in the core SACU countries within SADC and in South Africa in particular. This is also the case in the European Union (EU), where it has been proposed that a reduction in trade costs will serve to increase the concentration of industries with increasing returns in the core countries while peripheral countries will specialize in constant returns manufacturing and other non-industrial activities. Given the variable state of SADC's economic development, this could be seen as a catalyst for intra-industry trade with supply chains being set up throughout the region.

Herein lie two potential pitfalls for the SADC:

- Poor infrastructure in some of the less developed member nations may divert industrial development and its accompanying foreign investment to other areas.
- South Africa, which has as a highly unionised labour force, pays relatively high wages compared to the rest of the SADC region. Free movement of labour across the borders may encourage a country such as South Africa to base their labour intensive production in parts of the region where labour is cheap. Naturally, this not only presumes that the transaction costs of moving goods around the region are not prohibitive – it also assumes that the infrastructure to move the goods from one production facility or market to another exists.

Distribution of trade benefits

This is perhaps the greatest concern regarding the SADC FTA, namely that the benefits of free trade will not accrue equally to all participants. In fact, there is nothing in trade theory that guarantees an equitable distribution of trade gains.

However, in order for a free trade agreement to be sustainable in the SADC, all participants have to experience a net benefit from participating even if equity cannot be assured. The proposal outlined above i.e. that the net "gainers" somehow compensates the net "losers" is an interesting one in this respect.

Labour market and investment implications

Consumer gains from lower prices

There could be consumer gains from the formation of a free trade area as consumers and buyers of intermediate goods and machinery imported from SADC face lower prices.

Manufacturer gains and losses

From a manufacturer perspective however, the increased competition from SADC imports could have both positive and negative effects. It is likely to force local producers to increase their quality and efficiency – if they are not able to do this for some reason however, they may be forced to close down. This would naturally lead to increased unemployment in the domestic market and may even lead to market failure in the region.

Fiscal and budgetary implications of tariff changes

As tariffs are reduced, so is the government revenue derived from those tariffs. This impact is likely to vary from country to country depending on their respective dependence on customs revenue. In the SADC region, this dependence varies greatly between countries.

The broader the domestic revenue base, the less likely a country is to be dependant on customs revenue. It could then be argued that the reduction in customs revenue would have a positive effect as it is likely to promote steps to increase the domestic revenue base – a healthy policy reform.

It is likely that **all states will have to undertake some form of fiscal adjustment measures** to offset expected losses. If alternative sources of revenue cannot be found, governments may have to find ways to reduce expenditure and this may impact negatively on much needed public service provision. The net outcome of this is uncertain.

Multiplicity of trade agreements and treaties in the SADC region

The various trade agreements already in force in the region will

- **make it easier to form a single regional trading bloc** - as protagonists of regional integration will already have experienced the benefits of trade co-operation, thus reducing opposition to further integration.
- **Improve infrastructure** - The existing agreements may have precipitated the improvement of infrastructure between the members of the agreement.

Trade agreements and treaties in the SADC region

The Southern African Customs Union (SACU) covers three of SADC's five major exporters namely South Africa, Botswana, and Swaziland as well as Lesotho and Namibia. SACU provides for virtual free trade between its members and as a customs union, also has a common external tariff structure for extra regional trade.

The Common Market for Eastern and Southern Africa (COMESA) covers ten of the fourteen SADC members and is currently planning the next stage of its development which includes the establishment of a Common External Tariff and Customs Union. This is likely to be undertaken with a core group of countries initially and then filtered out to remaining members.

A **number of bilateral agreements exist between SADC members**, allowing either preferential or free trade. As such, the majority of intra-regional trade is already taking place in either zero duty or substantially discounted rates.

The potential pitfalls of these pre-existing agreements include

- **the relationship between South Africa and the non-SACU SADC countries**, a relationship which (in an economic sense) has not yet been established on formal grounds in all cases and which may raise some concerns as discussed previously.

- **Loss of revenue** - although tariffs in the region are low, in some cases, the revenue derived from them constitutes a substantial portion of government revenue.

- **Non-tariff barriers** (NTBs) - NTBs still exist and are largely related to administrative and bureaucratic inefficiencies; these include communication problems, customs procedures, transport problems, lack of market information, and other border procedures.

- **imbalance of economic power** - existing multilateral agreements in the region have created an imbalance of economic power.

Estimated impact of SADC FTA on government revenue for non-SACU SADC countries

	%Change in customs revenue	Customs revenue as % of total	% change in revenue
Angola	-1.8	4.3	-0.08
Malawi	-23.9	22	-5.26
Mauritius	-17.0	33.5	-5.7
Mozambique	-5.8	22.2	-1.29
Tanzania	-5.8	27.6	-1.6
Zambia	-28.7	8.6	-2.46
Zimbabwe	-32.2	17.2	-5.55

: CREFSA estimates using data from Evans (1997) for column 1 (except for Angola where the data is from the IMF Staff Country Report, 1995), as quoted in Hess (2000)

Estimates in column two are for 1996, except for Angola where they date back to 1994. (Hess, 2000)

How to achieve an acceptable distribution of costs and benefits

Recommendations of how to achieve an acceptable distribution of costs and benefits of enhanced trade integration in the SADC include:

- **The reduction of the sensitive products list –** particularly amongst SACU countries would ensure that countries already dominant in the production of certain goods are not inordinately protected from regional competition.
- **The elimination of non-trade barriers** will also ensure that the free trade agreement achieve the objective of enlarging the effective market of member countries.
- **The development of inter- and intra-industry trade** in order to establish complete supply chains within the area.
- **Fiscal adjustment and compensation** for the loss of government revenue from the reduction of trade tariffs and customs revenues.
- **The provision of basic infrastructure** underpins the facilitation of production and trade.
- **Financial sector reform** to ensure Africa's development and competitiveness.
- **The establishment of a supra-national body** which not only regulates trade within the area but which also has an intervention portfolio on trade-related conflicts and; and a charter of appropriate remedies and penalties agreed on by the member countries. The idea is certainly not to remove control over a country's trade from its elected government. Rather, the role of each of these government's should be to participate in the running of the supra-national body which has strictly defined parameters of authority.

Conclusion

The region's fear that the benefits of free trade will be concentrated within the SACU region and within South Africa particularly, are not unreasonable. However, if a system is set up as discussed earlier, whereby the countries which gain more in the initial stages compensates those countries which gain less in the initial stages by importing more from those countries or offering them preferential prices on goods – then the region as a whole is likely to benefit.

Cassim's study has demonstrated that the real work involved in increasing intra-regional trade involves an assessment of the limitations that are placed on potential regional trade by structural characteristics of the economies involved as well as the policy structures within each member country. The approach that is recommended is not a piece-meal approach but rather a holistic and dynamic one. Regularly monitoring needs to be fed into a reactive adjustment structure and national political concerns need to be placed second to regional growth and integration. The success of a free trade agreement in the SADC region is not unthinkable, nor is it even unlikely, but it does require a unique African solution to unique African circumstances.

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