

Trade Liberalisation: What exactly does it mean for Lesotho?

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Summary and Key Points

As the euphoria of trade liberalisation is being replaced by hard and realistic analysis, a worrying feature is that the gains from comprehensive liberalisation are being reduced. This is especially so for the southern African region, as factors such as the loss of preferences into richer markets and the non-compensated losses from tariff revenues in the smaller Southern African Customs Union (SACU) states are being examined in detail. A particular feature for SACU is the issue of liberalisation impacts upon the protected clothing and auto sectors, and that is being brought to the fore with talks of a Free Trade Agreement (FTA) between China and SACU and the US and SACU respectively. Here, analysis suggests a potential cost to both sectors, and for the clothing sector with China adjustment costs on a par with global liberalisation but without the widespread compensatory gains that global liberalisation may bring to other SACU sectors elsewhere. Complicating both current and future clothing sector policies in South Africa is the potential impact upon Lesotho's similar sector, with the difference here being that rather than an import substitution issue there is an almost total reliance in Lesotho upon a narrow range of clothing exports almost exclusively to the US.

This is not to say that SACU must shun trade liberalisation; it is to say that it must carefully examine all the issues involved before committing to further trade agreements. Additionally, South Africa must recognise its new responsibilities, both legal and moral, under the new SACU agreement in this area of trade policy, in both industrial policy and tariff revenues.

Based upon an assessment of 2005 imports into South Africa against the 2006 SACU tariff rates, at the mid-point of the Trade, Development and Co-operation Agreement (TDCA) and with SADC preferences now fully operationalised, these preferences reduce the tariff revenues by just under two billion rand, and extending the TDCA preferences to their end point adds another one and a half billion rand to this loss. These figures represent some 11 percent of the potential tariff revenues in the absence of the TDCA and SADC preferences. Should both the US and China be granted TDCA preferences the revenue loss would be another three and a half billion rand, and even a WTO outcome that reduced South African bound rates by 30 percent would reduce revenues further by R1.8 million. In addition, there will be tariff revenue losses of some R359 million from the trade creation/trade diversion switch to EU imports away from duty-paying imports, and the TDCA is currently being reviewed. Here we would expect the EU to seek concessions in the motor vehicle sector that currently provides the bulk of tariff revenues in the absence of preferences.

On the basis of this information the revenue potentially available to Lesotho from the SACU Customs pool will decline by some 11 percent over the next few years, with further reductions a distinct possibility. As this revenue represents one half of the total Lesotho government revenue, the consequences will be crucial. To assess how crucial we feed this revenue loss into a macroeconomic model of the Lesotho economy. The results show a reduction in government expenditures in the next period and subsequent periods; that the Government budget moves into deficit in 2004 but subsequently shows a smaller surplus than is projected; and there is a reduction in gross domestic expenditures that rises to one percent annually. In addition, there are implications for projected capital expenditure, and should there be a down-turn in the vulnerable export of clothing under preferences to the US market these impacts would be greatly exacerbated.

Introduction

There is much activity in the global trade negotiating environment, with world trade talks and multiple bilateral and regional trade agreements all progressing simultaneously. SACU/South Africa is embracing this concept with a view to furthering its bilateral trade, and the local stage also became a more active place during 2005. Pending the resolution of a few outstanding issues, the preferential trade deal with the South American Mercosur countries signed in December 2004 seems to be on track, and the free-trade agreement between SACU and EFTA (Switzerland, Norway, Iceland and Liechtenstein) has virtually been concluded. Talks with the US are scheduled to resume after a yearlong time out period, and SACU members are in serious discussions with the European Union (EU) about Economic Partnership Agreements (EPAs). Discussion about a trade deal with India is imminent, and SACU is considering starting free-trade talks with China. Others on the horizon include an examination of free-trade partners in Africa, and other countries such as Singapore, Thailand, Sri Lanka and Turkey have expressed interest in discussions with SACU. Meanwhile, the Sixth WTO ministerial conference in Hong Kong in December 2005 at least kept the Doha Development Round on track, and all countries generally recognise that FTAs are a second-best option to global trade liberalisation.

These FTAs are designed to liberalise trade between economies as countries seek to open up opportunities for productive commercial partnerships and other forms of cooperation. Economists routinely produce sophisticated computer models decreeing that the benefits of such liberalisation are of a particular figure. The problem, however, is that these figures contain considerable variations, and, more worryingly, these figures are retreating as the models are increasingly scrutinised.

One important point now being emphasised by these trade models is the tariff revenue loss to many developing countries. For SACU, this revenue is mostly collected at the South African border and shared among the SACU countries on the basis of the new revenue sharing formula. This paper will examine the South African (SACU) imports during 2005 and assess the likely revenue losses accruing to that pool as a result of trade agreements. This revenue is crucially important to both Lesotho and Swaziland in particular, as it constitutes around half or more of total government revenues.

From there, the paper will examine the potential exposure to Lesotho from these tariff concessions and trace the likely impacts of the reductions through the economy. This will be done by employing a macro-economic model of Lesotho's economy.

Why Lesotho? Because Lesotho, a small open economy that as a member of the world's oldest Customs Union and therefore no trade policy per se but relying on revenues from the SACU Customs for half of its government revenues while effectively having duty-free access into both the EU and US, is the best example in Africa of a country that has very little to gain from tariff preferences itself but faces an enormous down-side in the way of preference erosion and tariff revenue losses. Lesotho is also an LDC and, as such, is eligible for trade preferences into its present and potential markets, although the potential value of these preferences is being eroded by multilateral progress to reducing average tariffs and by the application of bilateral free trade

agreements extending these preferences to others. Lesotho is also a member of the Common Monetary Area and with its currency fixed at par with the Rand, so consequently Lesotho does not pursue independent monetary policy and is therefore dependent on fiscal policy for macroeconomic management.

Specifically therefore, we want to address the questions of:

- What are the likely aggregate gains from trade liberalisation to South and Southern Africa?
- What are the actual tariff revenue losses to SACU?
- Based upon these losses, what will be the impact upon Lesotho's economy?

Section Two. Trade Models: Strengths and Weaknesses and what they say about Africa

Why are the gains shrinking? Part of this is that some of the assumptions are being re-visited (employment, for example), while the newer version of the GTAP model enables analysts to use better trade and tariff data and incorporate both the EU expansion and China's WTO accession into their now-updated base work. These combinations are making a huge difference. Some of the more optimistic models employ dynamic and economies of scale assumptions that extend the scope and range of these gains, and these assumptions are rightly viewed with some scepticism. More importantly perhaps from a developing country perspective, is that the latest models are able to incorporate both loss of tariff preference and loss of tariff revenues into their analytical framework. For many countries this is crucial

WTO researchers have simulated the impact of Economic Partnership Agreements (EPAs) for countries of the Southern African Development Community (SADC)¹. Specific findings of their study are: (1) EPAs with the EU are welfare-enhancing for SADC overall, leading also to substantive increases in real GDP, but (2) the possibility of the EU entering an FTA with other countries, such as Mercosur, reduces estimated gains, but they still remain largely positive, and (3) estimated gains need to be revised downwards if agriculture liberalisation is not as far-reaching as a reduction of import barriers for manufactured products. That, unfortunately, is not the end of the study, as closer examination shows the need for the SACU tariff pooling formula to be adjusted to reflect new import patterns as tariffs are removed, as, with respect to tariff revenue losses, the 'results for Botswana and the "Rest of SACU" region are wildly exaggerated' and lead to a significant welfare loss for the BLNS countries. We suggest that this loss is not an exaggeration; it is consistent with more modest tralac research on potential SACU FTAs.

The welfare loss is also consistent with the findings of very recent research looking at a damning analysis of recent EU FTAs². A paper by Joe Francois and others starts by strongly challenging the legitimacy of many of the EU agreements on the basis of GATT Article XXIV and the agricultural exclusions, and finishes by highlighting the considerable welfare loss to third parties of even these limited agreements. For example, as a result of the TDCA, Botswana is estimated to lose \$384 million annually in real income³, a figure that represents around 10 percent of Botswana's total national income. And a recent IMF study on tariff loss from trade liberalisation found that high-income countries have recovered these revenues with ease, middle-income countries have recovered only about 35–55 per cent, but low-income countries have recovered essentially none of the tax revenues they lost.⁴

¹ Keck, A. and Piermartini, R. / World Tourism Organization (WTO). 2005. *Economic impact of EPAs in SADC countries*.

² Francois, J., McQueen, M. and Wignaraja, G. 2005. European Union – Developing Country FTAs: Overview and Analysis. *World Development*, Vol 33, No 10, pp 1545-1565, 2005.

³ As GTAP version 5 is used in the analysis, no comparable data is available for Lesotho in particular.

⁴ Baunsgaard, T. and Keen, M. 2004. *Draft Working Paper, 'Tax Revenue and (or?) Trade Liberalization*.

A notable feature of the December 2005 WTO Hong Kong Ministerial was the use and citation of models by many disparate groups that in the past have not been known for their support of such models. The reason for this support is however quite simple; the more recent ones are showing a considerable reduction in global welfare gains from trade liberalisation, and in particular an almost-disappearance of the gains to developing countries, the very group the Doha Development Round was launched to support.

A good place to review this is the paper by Frank Ackerman entitled ‘The Shrinking Gains from Trade: A Critical Assessment of Doha Round Projections’⁵. This work details how the gains are becoming both smaller and skewed towards the developed countries rather than poverty alleviation in the developing world. In another work widely cited at Hong Kong the highly respected World Bank team of Kym Anderson and Tom Hertel et al are revising their benefits downwards to a miserly \$3.13 per head in the developing world (in contrast to the \$79.04 per head in the developed world)⁶. Note that these gains are not repeatable gains, but rather a once-only step upwards. Again, for our region this actually overstates the gains in some countries, as the loss of tariff revenue is not fully factored in.

The UN Economic Commission for Africa (UNECA) has used both the GTAP general equilibrium model and the WITS/SMART partial equilibrium model to examine the impacts of EPAs,⁷ with results indicating that:

1. the EU will gain more than Africa, especially if the EU does not comprehensively open its markets;
2. intra-regional trade and intra-Africa trade will reduce;
3. tariff revenues losses will be ‘challenging’ (Seychelles 8.1% of fiscal revenues);
4. full reciprocity will be very costly for Africa; and
5. issues of governance and supply side constraints remain crucial.

While their GTAP analysis is competent, it suffers the limitation of the version 5 data base and an aggregated sectorial base, which highlights that it is only with the version 6 releases that Africa can be seriously modeled. However, their general conclusion that the sequencing of reforms is critical is a valid one; unless Africa is given time to address its chronic supply-side and infrastructural constraints, tariff reductions will both destroy the industrial infrastructure and

IMF, September 2004.

<http://www.imf.org/External/np/res/seminars/2004/tbmk.pdf>

⁵ Ackerman, F. 2005. The shrinking gains from Trade: A critical assessment of Doha Round projections. *Global development and Environment Institute Working Paper* No. 05-01, Tufts University, October 2005.

⁶ edited by Anderson, K. and Martin, W. (eds) 2005, “Agricultural Trade reform & the Doha Development Agenda” and Hertel, T. and Winters, A. (eds) 2005, “Putting Development Back into the Doha Agenda”

⁷ Based on a presentation by Remi Lang to tralac EPA Conference, Cape Town, 13 – 14 October 2005. This team is currently revisiting the GTAP analysis using Version 6 (personal communication).

seriously erode the revenue base.⁸ The WITS/SMART model indicates that there will be trade expansion for SADC, but that up to 30 per cent of this is merely trade diversion towards the EU. This has the implications that (a) the region overall is paying the price for not sourcing from the lowest cost options⁹ and (b) the direct tariff loss is accentuated. We consider that, in reality, given the complexities of the SACU tariff sharing mechanism and the uncertainties associated with the review of the TDCA the tariff revenue loss for the BLNS countries in particular may be underestimated here. We are also concerned that Africa continues to lag in the productivity stakes (the best measure of infrastructure competitiveness) internationally.¹⁰

Other research that warns of the trade creation/diversion costs of the EPA and potential tariff revenues loss is the review by Szepesi and Bilal.¹¹ They consider that potentially trade creation does outweigh diversion, but there is a considerable diversion effect, and that revenue losses are crucial in some countries. The World Bank also finds that EPAs offer considerable potential benefits to Sub-Sahara African (SSA) countries, but they also pose a number of policy, administrative, and institutional challenges, including replacing forgone tariff revenues, avoiding serious trade diversion, appropriately regulating liberalised service industries, and liberalising internal trade. To achieve pro-development outcomes through the EPAs, it is essential both that the SSA countries and organisations concerned be well prepared for these negotiations and that the EU adopt a benevolent, development oriented approach to them, subordinating its commercial interests to the development needs of the SSA countries.¹²

Recent papers that contain excellent reviews and analysis on the issue of tariff revenue and preference losses for Africa and the consequential overall welfare loss include Giblin and Matthews and Osakwe.¹³ A common theme is that partial liberalisation in the developed countries

⁸ Many authors have forcefully made the point that the Southern African region is not ready for trade liberalisation until at least some of these conditions are in place (see, for example, SAIIA Trade Policy Working Paper No2, 2004 by Talitha Bertelsmann-Scott).

⁹ While the gravity model approach is a useful empirical tool for examining current and possibly latent trade flows, it does not have an underlying economic structure past that point and therefore cannot be used as a substitute for CGE analysis. The available literature relating to South Africa and SADC seems to concur that South African exports to the region are significantly above the level that a gravity model would suggest (thus confirming that South Africa dominates the region over and above what its relative size and economic power would predict), and that other intra-SADC trade is generally below predicted. However, Chauvin and Gaulier agree with us in cautioning against using the gravity model for Africa. On the other hand, Coulibaly and Fontage find that in west Africa the percentage of paved bilateral roads, the crossing of a transit point and the actual road distance all significantly alter trade flows – these factors are all negatively present in eastern and southern African outside of SACU.

¹⁰ The new ‘Washington consensus’ has shifted from trade promoting development to one whereby trade is good for growth but only when supported by policies that ensure investments in both human and infrastructural capacity (i.e. ‘good governance’). Many authors have made the point that the southern African region is not ready for trade liberalisation until at least some of these conditions are in place.

¹¹ Szepesi, S. and Bilal, S. 2003. *EPA Impact Studies: SADC and the regional coherence*. European Centre for Development Policy Management, INBrief, No 2B – September 2003.

¹² Lawrence E. Hinkle and Maurice Schiff, World Bank, June 2004

¹³ For a general list of these papers see http://www.uneca.org/atpc/theme_month.asp . Specific papers include “Emerging Issues and Concerns of African Countries in the WTO Negotiations on Agriculture and the Doha Round” by Patrick N. Osakwe, Trade and Regional Integration Division (UNECA), Addis Ababa.; and “Global and EU

accentuates the problems for the developing world. Giblin and Matthews use the ATPSM model to examine impacts of agricultural reform on Sub-Sahara countries, and find that countries in this region that (a) rely on trade preferences and (b) countries that are net importers of agricultural products suffer welfare losses from developed country reforms. Although not specifically analysed, Lesotho is an example of both category (a), although not for agricultural exports, and (b), a food importer. Giblin and Matthews also cite the similar analysis undertaken by David Vanzetti and others at UNCTAD examining welfare effects of NAMA reforms that comes to a similar conclusion – gains come at the cost of lower tariff revenues, lower output and labour market losses in many developing countries. Although Osakwe also concentrates upon global agricultural reform, he provides an excellent background to the African problem of tariff revenue losses and cautions that the option of switching from trade to domestic taxes has not led to recovering revenues in many instances. He also brings up the oft-overlooked issue of adjustment costs in African economies that generally do not have social safety nets.

In summary, it is clear that the new generation of trade reform analysis is delivering disquieting news for Africa. While reforms are necessary, their own supply side constraints and non-tariff measures in export markets mitigate the abilities of many countries to take advantage of new export opportunities on the one hand. On the other hand, lowering domestic tariff barriers invite enhanced imports that lead to tariff revenue and output losses, and, for many, preference erosion in their export markets reduces their manufacturing opportunities and higher world prices lead to increased costs for net food importers. These problems are accentuated by partial reforms in the developed countries. Additionally, regional agreements such as the proposed EPA may lead to trade diversion with its consequential costs to the developing countries in Africa.

Section Three: Tariffs and tariff revenue

The SACU Revenue Sharing Exercise and general background to Lesotho

The Southern African Customs Union (SACU) is the oldest customs union in the world. The Customs Union Agreement, signed in 1910, was replaced by the SACU Agreement of 1969 and, more recently, with the SACU Agreement of 2002. The new Agreement has sought to create a more democratic structure and to enable the BLNS to participate more actively in the SACU decision-making process. It was ratified in July 2004 and the new revenue-sharing formula came into operation from 1st April 2005.

The Agreement states that the revenue share accruing to each member state be divided into three components: a customs pool (net of industrial policy rebates), an excise pool and a development component (funded from the excise pool prior to any distribution of the main body of that pool). The customs component is allocated according to each country's share of total intra-SACU trade, excluding re-exports. The main excise component will be shared on the basis of GDP, and the development component of the excise pool which has initially been fixed at 15 percent of that excise pool and distributed to all member states according to a separate formula that currently allocates 21 percent to Lesotho. The shares are calculated on the basis of an agreed forecast of the Customs and Excise Pools but any deviation between the forecast and the actual collections will be distributed (or collected, in cases where the distribution exceeds the collection) in arrears.

Based upon the most recent data for Lesotho, SACU receipts provided an estimated 49.7 percent of total government revenues for 2006 and this share is estimated to increase to 53.4 percent in 2007. Therefore, any tariff revenue losses are likely to be crucial to Lesotho. The second distribution under the new formula was made in late 2005 (for financial year 2006/07) and Lesotho received a 12.18 percent share of the Customs Pool, providing revenue of R2,189.5m, which dominates excise revenues of R78m and the development component of R513.5m. In addition, Lesotho will receive some adjustments carried over from the old revenue sharing system, but this paper concentrates exclusively on the Customs Pool and ignores these adjustments, the excise pool and the development component.

The tariff pool distribution mechanism bears no direct link to the actual imports into SACU from whence this revenue pool arises. The pie is baked according to one recipe and sliced according to a totally different formula. It is fair to say that this new system has caused some implementation issues as members submit an import figure that has proved difficult to reconcile and verify for their share of a fixed pool.

Normally in any analysis of the benefits to trade liberalisation there is a trade-off between the gains from enhanced efficiency domestically, improved export opportunities and performance and lower import costs to consumers on the one hand against possible job losses and reduced tariff revenues on the other. For Lesotho such a trade-off does not exist. As an LDC it effectively has duty-free access into the EU under the Everything but Arms (EBA) and the US under the African Growth and Opportunities Act (AGOA). However, exports almost entirely consist of a narrow range of clothing exports to the US under AGOA, and an analysis of the AGOA shows Lesotho to be the star pupil in the class in terms of manufactured products that provide real benefits to the working class citizens. Moreover, trade liberalisation generally and

the end of the WTO Multi-Fibre Agreement, threatens preferences losses and enhanced competition globally that may well spell the death knell for this industry¹⁴. Crucially, under the previous SACU Agreement, Lesotho had limited control over its trade policy, and indeed had no direct input into the negotiation of the TDCA that is now reducing its government revenues. This situation changed with the implementation of the new SACU agreement because that mandates SACU and not South Africa to negotiate trade agreements. It should also be noted that Lesotho is a member of the SADC 7 which is negotiating an agreement with the EU under the proposed Economic Partnership Agreement (EPA) framework in parallel to the SACU and EU review of the TDCA.

Lesotho is therefore in a situation of little upside but a considerable downside from trade liberalisation, and is not in a position to directly decide the outcome of any negotiations. The EU has emphasised that there will be a development component under any EPA, and Lesotho must use that promise to secure a meaningful outcome from either or both of the TDCA review and the EPA process. Also, on the basis of current exports from Lesotho, the point must be made that the prevailing rules of origin are effectively blocking clothing exports from Lesotho to the EU, whereas the more liberal regime operating into both the US and Canada has allowed strong exports from Lesotho. Other than recognition that an operational rule of origin regime should be designed to assist LDCs and Lesotho in particular, there is little else in these EPA negotiations to compensate for any revenue losses from SACU tariff reductions. This paper will now consider exactly what these losses are likely to be in order to make the point forcefully to both South Africa and the EU that current SACU tariff preferences are hurting Lesotho and that this will be accentuated as the TDCA rolls out on its current track and its review and further trade agreements are considered.

Theoretical Duties, Rebates and their impacts upon revenue collections

During 2005 South Africa imported goods to the value of R 350.6 billion. Assessing these imports against the SACU 2006 tariff schedule¹⁵ at the HS 6 and 8 digit level we calculated that, in the absence of tariff rebates, these imports would have paid some R 29.7 billion at an average rate of 8.35 percent. This is shown in Table 1, along with the source of these imports and the tariffs by these sources¹⁶.

¹⁴ See Chapter 3 and 4 in Sandrey, Ron, Adelaide Matlanyane, David Maleleka and Dirk Ernst van Seventer, "Lesotho: Potential Export Diversification Study", tralac Working paper No 10/2005, December 2005. Available online at www.tralac.org

¹⁵ Available on http://www.sars.gov.za/tariffs/Loose_Leaf/lltbookmainsch1.pdf. Note that this is a live document, thus the 2006 rates were used rather than the 2005 values.

¹⁶ In addition to the rebates there are two other assumptions made. The first is that tariff rate quotas (TRQs) are not taken into account for the agricultural imports. We assess that this would reduce the 'potential' duty collection by around R150 million. The second is that imports assessed for duty in the BLNS countries are also not considered. We believe (anecdotally) that these may be around three percent of the total dutiable imports. Thus, these two are somewhat off-setting.

	Total	EU	USA	China	SADC	Mercosur	Other
Imp Rm	350,611	133,530	27,323	31,469	12,092	11,214	134,984
% share	100	38.1	7.79	8.98	3.45	3.2	38.5
Tariff Rm	29,725	11,173	1,181	4,012	460	1,575	11,324
rate%	8.35	8.37	4.32	12.75	0.07	14.05	8.39

Source: tralac calculations from World trade Atlas data and the SACU Tariff Schedule.

Rebates

The WTO Trade Policy Review (TPRM) of Southern African Customs Union cautions that “the duty to collection ratio underestimates the level of tariff protection because the actual tariff revenue, as a result of tariff exemptions and concessions, preferential tariff treatment, and inefficiencies in collection does not reflect the real tariff burden borne by fully dutiable imports”¹⁷. Conversely, since we are looking at the mirror of not accounting for these factors, the calculations that we make based on actual imports and the SACU Tariff Schedule will overestimate the revenue collection.

As is normally the case with specific export sectors, imported inputs are eligible for a full duty refund provided the consequential end product is exported outside of the SACU region. However, there are additional assistance packages available to exporters. Provision exists for rebate of duties on the importation of raw materials and components used in the manufacturing process. A substantial number of rebate facilities already exist in respect of specific industries and raw materials/components. An industrialist may apply for the creation of additional rebate facilities if he can demonstrate that the import tariff on the raw materials/components concerned has a substantial effect on his production cost and that he needs the rebate to be competitive against imported products that compete with his end-product. Each application is considered on the merits of the case. Provision also exists for the rebate or refund of the import tariff on raw materials/components used in the manufacturing, processing, finishing, equipping or packing of goods for export. The rebate or refund of duties in such cases is subject to a permit but permits are readily granted in an endeavor to boost South Africa's export performance. These rebates and relief of duties exist for cases in which the imported commodity will be used in a subsequent domestic manufacturing or other add-value process. They apply mainly, but not exclusively, to the motor vehicle industry under the MIDP; an import/export complementation arrangement, whereby the local value-add of components or built-up vehicles exported earn credits that can be used to rebate import duties on components and vehicles. The MIDP has been reviewed twice and is now scheduled to continue until 2012.

Indications of the value of the rebates suggest that these are around one third of the potential tariffs calculated here. One source justifying this is the press release from Trevor Manuel, Minister of Finance, 3 April 2006, where he announced that Customs duties to the value of R18.4billion had been collected to the year ending March 2006 (a similar but not exact time

¹⁷WTO Trade Policy Review of Southern African Customs Union, 2003, Box III.1. At http://www.wto.org/english/thewto_e/countries_e/south_africa_e.htm#tpr

period to our analysis. Another is a paper examining the extent to which South Africa has liberalised its trade in recent years,¹⁸ where Edwards calculates an average MFN rate of 8.3 percent (very similar to our 2005/06 rate), but sets this against an actual collection rate of 6.1 percent. Furthermore, in the motor vehicle sector, Edwards calculates an MFN rate of 15.1 percent set against a collection rate of under half at 7.2 percent. Given that our estimates are for some 58 percent of the pre-rebate duties being assessed on the 19 percent of total import classified as motor vehicles, this reinforces the estimate of rebates being one third of the potential duty take.

Finally, this paper promotes the thesis that the revenue share for Lesotho is declining as a result of the TDCA and other tariff concessions. We must also acknowledge that this revenue pool allocation contains an income transfer from South Africa to the BLNS countries. The WTO TPRM calculates that on the basis of 1998/99 trade South Africa would have contributed about 80 percent of the tariff revenue and its share would have been around 20.5 percent (although this calculation was under the old formula). Conversely, the BLNS would have contributed about 20 percent but their individual revenues shares would have been: Botswana 26.6 percent, Lesotho 13.4 percent, Namibia 24.9 percent and Swaziland 14.6 percent. Lesotho's share is close to its most recent 12.9 percent share. Thus, on this basis, around three quarters of the revenue sharing could be considered to be an income transfer from South Africa to the BLNS countries¹⁹. However, conversely, under the 1969 SACU South Africa set trade policy and designed it to support RSA's industrial policy. This means that BLNS import South African products produced behind a protectionist wall and pay higher prices (as opposed to internationally competitive prices) while trade diversion has generated company and personal income tax for RSA. This represents a substantial transfer of resources back from BLNS to RSA. It was these anomalies that SACU revenue-sharing arrangements attempted to redress.

A look at FTAs and potential FTAs

It is important to make the point up-front that South Africa, the most developed economy within SACU, has by far the most to gain from increased trade. It negotiated the TDCA with the EU on its own in isolation from SACU, but now with the introduction of the new SACU Agreement any reviews must be undertaken together with the BLNS countries of SACU. Complicating this negotiation process is the fundamental fact that potential trade benefits for BLNS are negligible but the genuine revenue costs are substantial (especially for Lesotho and Swaziland).

¹⁸ Lawrence Edwards, "Has South Africa Liberalised its Trade?", University of Cape Town paper prepared for the Trade and Poverty Project, 2005.

¹⁹ Flatters and Stern calculate a difference between dutiable imports and intra-SACU imports for the BLNS that suggests an even higher income redistribution ratio of about six to one on the Customs revenue monies. "Implementing the SACU Revenue –Sharing Formula: Customs Revenue", Frank Flatters and Matthew Stern, April 2005. At http://qed.econ.queensu.ca/faculty/flatters/writings/ff&ms_nt_sacu_rsf.pdf

1. *The TDCA and the related review*

Background

South Africa's limited role in the Cotonou agreement prompted the negotiation of a Trade, Development and Co-operation Agreement (TDCA) with the EU. Coming into effect on 1 January 2000, the agreement aims to introduce bilateral freer trade over a 12-year transitional period. Although the TDCA permits South Africa a longer transition period (12 years) than the EU (10 years), and requires the EU to eliminate tariffs on a higher percentage of goods traded at the implementation time (95%) than is the case for SA (86%), a greater effort is arguably necessary of South Africa. In 2004 prescribed EU tariff changes affected only 25 percent of traded goods and their weighted average tariff was only 2.7 percent. South African tariff changes, on the other hand, affected 40 percent of currently traded goods in a context of a weighted average tariff of 10 percent²⁰. This seems far short of a comprehensive agreement, or indeed an agreement with much in the way of a development agenda.

The negotiating dynamics have become more complex following the introduction of the new SACU Agreement. By nature of that Agreement, the BLNS countries become de facto members of the TDCA with respect to imports from the EU, as, although mandated in the new SACU agreement, the collection of tariff preferences on intra-SACU trade from the EU into the BLNS is impractical. In addition, the SADC countries are supposedly moving to an FTA (to be succeeded by a Customs Union), and there is a scheduled review of the TDCA (but this time, presumably, under the new SACU Agreement). Bertelsmann and Draper dance cautiously around many of the issues that will come up during this TDCA review, and in particular, the role of and negotiating positions for the BLNS countries.²¹

Against the confusing tangle of global trade agreements there entered an unwillingness from other developing countries to continue to agree to waivers from WTO rules for EU-ACP non-reciprocal preferences beyond 2007. This necessitated new market access commitments to be made on the basis of reciprocity; the so-called Economic Partnership Agreement (EPAs) between the EU and different country groupings within the ACP. At the same time Least-Developed Countries (LDCs) from the ACP region are part of the negotiation process, but they continue to enjoy duty- and quota-free market access under the EU's unilateral Everything but Arms (EBA) initiative given to all LDCs. So what are the incentives for an LDC such as Lesotho to negotiate an EPA with the EU? And, more importantly, what will be the role of South Africa within an EPA that involves its SACU partners? Conversely, if the BLNS countries concentrate upon the TDCA review with South Africa, where does that leave them in EPA negotiations?

²⁰ Mmatlou Kalaba, Ron Sandrey & Dirk Ernst van Seventer, "Analysis of Trade Between South African and the EU and a preliminary attempt to examine the impact of the EU – SA FTA on Trade", TIPS Working Paper, 2005

²¹ T.Bertelsmann-Scott & P.Draper "The TDCA: perspectives for EU-South and Southern African relations", Trade Negotiations Insights, From Doha to Cotonou Vol.4 No.1, January-February 2005. http://www.ictsd.org/tni/tni_english/TNI_EN_4.1.pdf

The TDCA to date

In an earlier paper based on analysis of trade for the December 2004 year²² tralac assessed the possible impact of the TDCA on duties paid at the respective borders. This again assumes (a) no rebates on the SACU side – heroic, and (b) that South African trade with the EU is not eligible for GSP preferences. For RSA/SACU imports from the EU during 2004 an average duty of 9.75 per cent would have been assessed, giving possible duties of R9.58 billion. Extrapolating these same imports through to year 12, the final year would result in an average duty of 7.93 per cent or R7.79 billion in duties. This is a reduction of 1.82 percentage points from 2004, which itself was down by 0.44 percentage points from the year zero base.

Conversely, at the EU border, South African imports would have paid, on average, a lesser 3.10 per cent duty at 2004 trade and duty rates. By 2009 this will have reduced to a 1.92 percent average, a reduction of 1.18 percentage points from 2004, which was, in itself, down from a much higher 4.99 percent base assessed at the MFN rate. By year 9 high duties will almost exclusively remain on agricultural products (if one classifies fish as agriculture); of the 300 HS 8 lines based on 2004 trade that will be facing duties at 20 per cent or above into the EU, only ten are non-agricultural products. The protected agricultural products are spread pretty much across the board, and feature the ‘usual suspects’ list of EU protection.

To update this information on the South African (SACU) side we extended the analysis as shown in Table One for 2005 imports to include (a) the EU tariffs that would have been paid in the absence of the TDCA preferences and (b) the tariffs that would have been paid if the duties were assessed at the end-point of the TDCA. Along with ignoring rebates, there is an assumption here that trade flows have not been and will not be influenced by these reducing tariffs, thus ignoring both income and substitution effects (trade creation/diversion). Results show that:

1. at the MFN rate, the imports would have yielded duties of R12,685 million at an average rate of 9.50 percent; and
2. at the end-point, these same imports would have yielded duties of R9,702 million at an average rate of 7.27 percent.
3. Thus, the duty foregone is R2,983 million, or a reduction of 2.23 percentage points in the assessed rate on EU imports.
4. At the same 12.18 percent share accruing to Lesotho, this means that, all else held constant, Lesotho’s government revenues from the pool will fall by R363 million from what it otherwise would have been.

The TDCA Review

Any thoughts on how this review may accentuate the tariff loss are of course pure speculation. We can however examine the current import flows from the EU and their associated tariff rates to

²² Ron Sandrey, “Trade Liberalisation: what exactly does it mean for South Africa?” tralac working paper No 4/2006, April 2006.

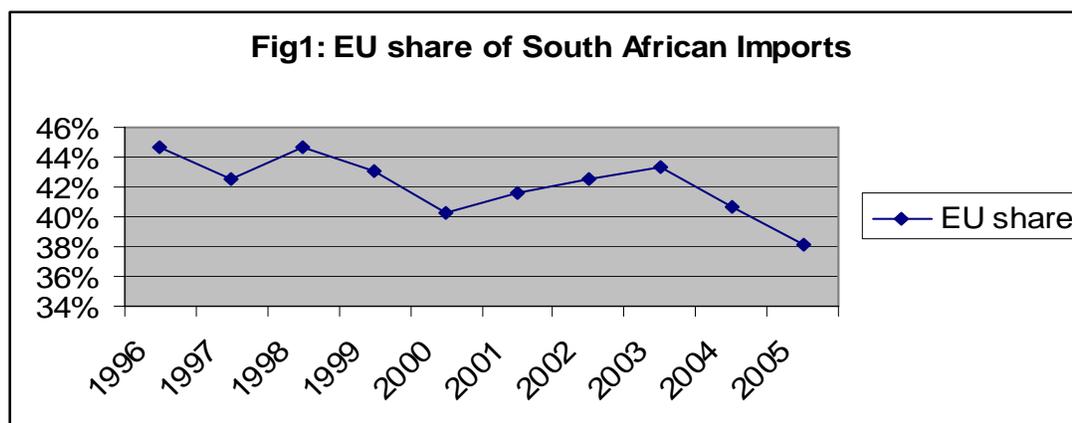
glean some information on where the EU negotiating priorities will be. Again, this ignores the vexing issue of rebates.

During 2005 some 14.9 percent of the imports from the EU were under HS Chapter 87, vehicles and their parts, with another 11.7 percent under HS 98, heavy duty vehicles under the SACU definition. This combined 26.6 percent of the imports ‘paid’ some 83.3 percent of the duties (ignoring rebates) under the 2006 tariff Schedule. Prior to the TDCA the applicable tariff figure for duties paid on the combined HS 87 and 98 motor vehicle imports from the EU would have been 74.4 percent of the total, while at the end point it would be a dominating 94.1 percent of the total duties assessed against EU imports. The reason for this is clear; in almost all other sectors the tariffs are either declining or going to zero, while for HS 87 they decline very modestly from 27.0 percent pre-TDCA to 26.3 percent in 2006 and 25.4 percent at the end point and for HS 98 they remain constant at 26 percent. Even against these modest tariff reduction vehicles and parts as defined in HS 87 only have increased from 5.8 percent of total imports in 1996 (and lesser 4.6%, 4.8% and 5.7% values in 1997, 1998 and 1999 respectively) to 14.9 percent in 2005.

To put the importance of the motor vehicles and their associated parts in perspective for the revenue pool should the TDCA reduce these vehicle tariffs in HS 87 and 98 following the full implementation by 10 percent it would, on current trade, reduce the tariff pool by 9.4 percent. Yet should the review abolish all other duties on EU imports into SACU it would only reduce the pool by 5.9 percent, a figure that is under two-thirds of the 10 percent reduction in vehicle tariffs alone. This illustrates the dominance of motor vehicle industrial policies in South Africa, a heavily protected and assisted sector that at a minimum leaves itself open to WTO challenges²³.

Impacts of the TDCA to date

Fig 1 shows the percentage share of EU imports in the South African market over the last ten years. During the early implementation years of the TDCA (2001 to 2003 inclusive), there is a steady increase of that share back to nearly the high points of 1996 and 1998, but over the two most recent years this share has retreated to their lowest levels of modern times.



²³See, for example, Frank Flatters, “The Economics of MIDP and the South African Motor Vehicle Industry”, 5 November 2005.

To give an indication of the very preliminary effects of tariff reductions we analysed South African imports from 1996 to 2005 inclusive at the HS 4 level and the associated tariff preferences to EU imports over this period²⁴. This preliminary analysis suggested that to date there has been limited effects of the preferences on imports shares into South Africa. Overall, from 1996 to 2000 inclusive, the growth rate of EU market shares was 2.09 percent, while from 2001 to 2005 this growth rate reduced to 1.75 percent. Comparing the growth rate in market shares over the second period with the 2006 (not 2005) preferences as measured in reductions in percentage points indicated a correlation coefficient of 0.035. Given the dominance of EU imports into South Africa this is a field for further examination, as there may well be a potential trade diversion effect that can be measured at the individual tariff line that will accentuate the welfare losses to SACU.

Trade Creation and Trade Diversion from the TDCA at the end point

As always, an FTA will result in both trade creation as new trade is forthcoming in response to the tariff changes and trade diversion as trade moves in favour of the preference gainer. The two can be summed to give an indication of the overall effect. The relevant point for this paper is that trade diversion in favour of the EU will result in fewer duties collected overall, and an overall welfare loss for SACU in general as trade is sourced from suppliers who may not generally be the lowest cost suppliers in the absence of duty preferences. Section One of this paper showed that the recent literature on the outcome from the proposed EPA is showing that trade diversion (along with customs revenue losses) is leading to significant welfare losses to many African nations from this phenomenon.

Using the time-honoured formula for trade creation and diversion as developed by Laird and Yates and applied in the WITS/SMART model²⁵ we calculated these effects at the HS 4 levels from the 2005 imports and the initial MFN and TDCA-end point duties²⁶. We applied the formula using demand and substitution elasticities of -1.5 percent, and note that any change to this will simply be a linear change to the results and can easily be calculated. At the end point of the TDCA imports from the EU (trade creation) will be R4,146 million or 3.18 percent above what they otherwise would have been. However, some R2,663 million of this is trade diversion away from other sources, giving an overall net effect of an increase in imports of R1,583 million. Duties collected (theoretically) on the new EU imports would be R73 million, but this is outweighed by the diversion loss from substitution of R432 million for another duty foregone into the Customs pool of R359 million and the consequential Lesotho share of R44 million. By HS Chapters, much of this stems from imports in HS 85, electrical machinery, and HS 39, plastics. Other than some increases in footwear, there are little impacts on the sensitive TCF sectors despite generous preferences, and limited impacts on the motor vehicles as preferences here are modest.

²⁴ We note the limitation of using 2006 preference rates for this exercise, so the results are indicative only.

²⁵ See, for example, the UNECA documentation at

http://www.uneca.org/eca_programmes/trade_and_regional_integration/documents/Analytical%20Methodology%20for%20EPAs%20Study.pdf

²⁶ This may give an overestimation as some of the effects are double-counted in that the TDCA have already been in operation for period, but, as shown above in Figure 1, the overall aggregate effects to date are not obvious.

2. The SADC FTA

SADC has evolved since 1980, and is, along with other objectives, currently striving for trade cooperation, market integration and general liberalisation in the region. This will generally operate under the framework of the Trade Protocol, which seeks to “further liberalize intra-regional trade in goods and services on the basis of fair, mutually equitable and beneficial trade arrangements”, albeit with differing time paths for members. The Trade Protocol, signed in 1996, is aimed at progressively establishing a SADC free-trade area, initially over eight years. However, progress has been slow. The Protocol was implemented in September 2000 after ratification by 11 members. Currently Angola, Seychelles, Madagascar and DR Congo remain outside of the agreement²⁷. To date all signatories except for Zimbabwe have translated their commitments into domestic enabling legislation. To establish the FTA, products have been grouped under three main categories (A, B, and C), with category C consists of products deemed sensitive by member states; these goods, limited to a maximum of 15 percent of each member's total merchandise trade, are to be liberalized between 2005 and 2012. The phase-down offers are country specific and are currently being implemented.

From January 2006 almost all imports from the non-SACU SADC members enter SACU at duty-free rates. The only exceptions as at March 2006 were items of used clothing and the motor vehicle imports. As SADC has very limited exports in the motor vehicle sector this is not really an issue and the liberalisation into the SACU market has effectively gone about as far as it can. These access conditions are not however reciprocated, although the SADC route-map indicates that a Customs Union will supersede the FTA by 2010.

3. MERCOSUR

The present position is that an agreement has been concluded between SACU and Mercosur (the common market of the Southern Cone which comprises Brazil, Argentina, Paraguay and Uruguay) in December 2004 and was scheduled to enter into effect in January 2006. In the agricultural sphere, Mercosur will grant duty-free access for several food products from SACU members, crude oil, salts, tanks, reservoirs and capsules. In return, SACU will grant duty-free access for a limited range of products and preferences for a few more. These lists are expected to grow as negotiations continue. The agreement has not been implemented as planned, and negotiators have yet to resolve a number of minor issues. Currently, based upon the preference lists, there is limited impact on the duties at the SACU border, with most of the change relating to preferences on imports of oilseed products from Argentina.

4. European Free Trade Association (EFTA)

In May 2003, the first round of negotiations for an FTA between SACU member states and EFTA got underway. The nine countries that concluded negotiations for a free trade deal in 2005 hope the agreement will be signed off by their respective trade ministers in April 2006, opening the way for ratification by June 2006. We have not been able to obtain the product list, but needless to say many agricultural products have been excluded from tariff liberalisation at the behest of SACU due to the high levels of agricultural subsidies present in the EFTA states. Currently EFTA has good access into SACU, with 88.8 percent of the imports at the HS 4 level

²⁷ Madagascar joined SADC in 2005 and Seychelles rejoined SADC in 2005 after having previously resigned.

by value entering at tariffs of 5 percent or below, and these imports only paying some 0.19 percent on average. Extending the same duty rates to EFTA as apply to the end point of the TDCA would reduce the average import duty on EFTA imports into SACU from a modest 1.73 percent to a very low 0.44 percent with a consequential revenue loss of R66.6 million.

5. The possible US/SACU FTA and AGOA

AGOA significantly liberalises market access to the US for 37 designated Sub-Saharan African (SSA) countries. Most exports under AGOA are duty- and quota free, but a special set of conditions governs the traditionally sensitive apparel sector. Some 45 of the 48 Sub-Saharan African countries are currently GSP eligible. Thanks in part to AGOA, South Africa's exporters have had unprecedented access into the US goods market with 77 percent of goods entering duty free in 2004 and the overall duty rate of only 0.27 percent overall.

Similarly, Lesotho currently has preferential access for its clothing exports, as discussed above. Here the goods exported are almost exclusively a narrow range of clothing goods that enter under AGOA preferences, and more specifically, a temporary derogation under the RoO. Maintaining this trade flow dominates any other opportunity that is on the trade priority horizon.

The SACU member states entered into formal negotiations for an FTA with the United States in July 2003. The stated US intention was to level the playing field in areas where US exporters are disadvantaged by the European Union's FTA with South Africa. The incentive for SACU to open their goods market is minimal, as it gains little new market access in return. Furthermore, the US trade representative's template for a free-trade agreement is demanding: complete opening of our services markets, onerous intellectual property rights, investment, labour and environment provisions beyond WTO commitments. Within SACU, countries do not share common policies on matters outside of goods trade; so therefore, internal policy harmonisation must be prioritised over external negotiations. Not surprisingly the negotiations have not progressed and the US congress is reportedly frustrated by the lack of progress to date and not prepared to wait for SACU to harmonise internal policies. Operationally, those on the SACU side expecting miracles should examine the nature of recent US "FTAs" and learn the protected nature of the US side of these agreements²⁸.

Notwithstanding these issues, should progress be made the US desire to gain an equal footing with the TDCA provides a focal point for examination. Based on the 2005 trade flows where the assessed duty on US imports of R1,181.2 million at 4.32 percent from table one, access under the final TDCA rates would reduce this by some 40 percent or R468 million to 2.61 percent. In a similar situation to the EU, vehicles currently show 55 percent of the duties on a much lesser 12 percent of the imports, again highlighting the role of that sector in possible negotiations for the SACU side.

²⁸ The current crop of US "FTAs" are comprehensive agreements notwithstanding the US refusal to entertain trade liberalisation in sensitive sectors in that they cover many elements of the modern FTA. Just how SACU, an agreement that essentially covers only trade in goods notwithstanding Articles 38 to 41 of the new SACU Agreement, will handle an agreement with the US that goes beyond the coverage and legal competency of the current SACU agreement is unclear.

6. India and China

SACU has framework agreements in place with both India and China in terms of which the parties are committed to conclude free trade agreements. These negotiations are in their infancy at present. Officials from SACU and India were to meet in India at the end of January 2006 to map out a working programme for negotiations towards a preferential trade deal. With regards to the mooted free trade deal between SACU and China, studies into the effects of such a deal are still under way in SA.

Should negotiations proceed with China and the Chinese negotiators seek TDCA end point terms, the implications for the revenue pool let alone the industrial sector within SACU would be dramatic. Under these terms the duty paid on 2005 imports would decline from R4,012 million at an average rate of 12.75 percent to R1,043 million (R2,969 million less) with an average of 3.31 percent. The reason for this is very clear: China is competing strongly in markets where the EU is not competitive and therefore South African trade negotiators saw fit to give generous concessions to the EU in these sectors. Conversely, China is not (yet) a strong competitor in the SACU motor vehicle and parts market.

7. The WTO and global negotiations

The Doha Development Agenda (DDA) Round of the WTO is still active, and at this stage it is difficult to predict an outcome to these negotiations as there are several proposals for tariff reductions on the table. However, we do know that any reductions will be driven off bound and not necessarily applied tariff rates, therefore we must examine these bound rates to glean some possible information of the effects of an outcome in the DDA for the SACU tariff revenue pool. There is a complication that SACU is not a member of the WTO, rather the individual countries are, and their WTO bound rates are not the same (just how these differences could be operationalised is unclear). We will proxy any outcome by using the South African WTO bound rates, and furthermore proxy the DDA outcome by assuming a 30 percent reduction in all bound rates for both Agriculture and non-Agricultural goods and use this simplification to assess at least a very preliminary indication for the tariff revenues.

Accordingly, we examined the individual tariff lines to assess whether or not this 30 percent reduction in bounds actually impacted upon the applied rates. For the most part it does not affect the majority of the trade. We caution that our results are preliminary and based on just one post-DDA outcome, but nonetheless they are indicative.

Results suggest that such an outcome would reduce the overall tariff take by a further R1,763 million. Most of this reduction would occur in HS 9801, imported motor vehicles where the applied rates are currently 26 percent and the bounds 30 percent (with no TDCA or SADC preferences). Much of the remainder (R868m) would be on imports from China, as the current applied rates are at or very close to bounds for many imports in the clothing and footwear lines²⁹.

²⁹ Of the calculated R868 million reduction should an agreement reduce bound rates by 30 percent, some R663m or 76 percent of the Chinese total is in HS lines 61 to 65 inclusive. This should provide a signal to SACU negotiators.

There would be very little impact on the agricultural imports at this stage (R48m, and most of this in dairy and related products).

Summary of tariff preference implication on revenues

The summary of changes in potential tariff revenues (ignoring rebates) from the calculations above is shown in Table 2.

Table 2: Preferences as they relate to 2005 imports							
	Total	EU	USA	China	SADC	Mercosur	Other*
Status Quo							
Imp R m	350,611	133,530	27,323	31,469	12,092	11,214	143,984
% share	100	38.1	7.79	8.98	3.45	3.2	38.5
A. Without preferences							
Tariff Rm	31,237	12,685	1,181	4,012	460	1,575	11,324
Rate%	8.91	9.50	4.32	12.75	3.81	14.05	8.39
B. Current situation, 2005 imports at 2006 tariff rates							
Tariff Rm	29,273	11,173	1,181	4,012	8.0	1,575	11,324
Rate%	8.35	8.37	4.32	12.75	0.07	14.05	8.39
Difference (B-A): – R1,964 mill							
C. TDCA end-point and Mercosur FTA estimates (2005 imports)							
Tariff Rm	27,802	9,702	1,181	4,012	8.0	1,537	11,324
Rate%	7.92	7.27	4.32	12.75	0.07	13.71	8.39
Difference (C-B): -R 1,471 million							
D. As above, but with Chinese & USA imports at TDCA end-point							
Tariff Rm	24,365	9,702	713	1,043	8.0	1,575	11,324
rate%	6.94	7.27	2.61	3.31	0.07	14.05	8.39
Difference (D-C): -R 3,437 million							

Where 'Other' refers to imports sources other than those shown.

The key points from Table 2 are:

- ❖ Without preferences, the duties would be R31.24m ('the potential base');
- ❖ With 2006 TDCA and SADC preferences, this reduces by R1,964m relative to the base;
- ❖ With TDCA end point and Mercosur FTA, this reduces by another R1,471m relative to the base; and
- ❖ Should both the US and China be given TDCA preferences, this would reduce by another R3,437m relative to the base.

Not shown is that should the WTO Doha Round reduce bound rates by 30 percent this would reduce by another R1,763m.

On the basis of this information we know that the revenue potentially available to Lesotho from the tariff pool will decline by some 11 percent over the next few years, with further reductions a distinct possibility. While the exact revenues will of course vary from any estimate at this stage, the relative percent reduction is firm. In addition, we note the possibility that Lesotho's relative

share will decline as the South African trade data for 2005 recorded imports from Botswana and Namibia of around R3 billion, thus increasing RSA's share of the Customs pool at the expense of BLNS, from the situation in which effectively no trade in diamonds from these sources has been recorded in the past. We are uncertain if this signals a change in historical trading patterns or merely brings the previous trade into the formal SACU revenue pool allocation calculations.

We will now move to the next stage of the paper, that of assessing the impact of these reductions on Lesotho's economy, keeping in mind that these revenues constitute just over half of total government revenues.

Section Four: the Model and Implications for Lesotho

In an ideal world we would have simulated a GTAP exercise examining the full CGE results of trade liberalisation for Lesotho, but even in the GTAP version 6 Lesotho is aggregated with Namibia and Swaziland. These three economies are totally different, and we therefore turn to a specifically Lesotho model. This model is a macro-economic Keynesian demand side model of the Lesotho economy, where output is determined from the demand side and the economy is demand driven, and the usual small open economy assumption applies³⁰. Structurally, it is a medium size Keynesian type model in which the following five sectors of the economy are modeled:

- The real sector
- The price sector
- The monetary sector
- The fiscal sector
- The external sector

The **real** sector incorporates the external sector and estimates private consumption, total investment, real exports and imports of goods and services to determine aggregate demand in the economy. The specification of real private consumption follows the simple Keynesian Absolute Income Hypothesis and is a function of real disposable income, defined as nominal disposable income deflated by the GDP deflator. Real total investment is a positive function of real GDP and a negative function of the real Treasury bill rate of interest, defined as the nominal Treasury bill rate less the CPI based inflation rate. Real imports of goods and services are a positive function of real domestic expenditure and a negative function of the relative price of imports, where real gross domestic expenditure is defined as the difference between real GDP and real net exports. Real exports of goods and services are specified as a function of world output and the relative price of exports (real exchange rate). The real sector is closed by specifying the national income identity that defines real GDP as the sum of the real private consumption, real government consumption, real total investment and net exports.

The **price** sector estimates consumer prices. Consumer prices are specified as a function of import prices and the government wage bill which is taken as a proxy for nominal wages. In addition to these, consumer prices depend on the nominal stock of broad money, M2, in the long run.

³⁰ A copy of the full model is available on request.

The **monetary** sector captures the demand for broad money, M2. Demand for broad money is specified as a function of real gross national income and the real Treasury bill rate.

The **fiscal** sector estimates broad revenue and expenditure components. It estimates direct and indirect taxes as well as total government expenditures. Both direct and indirect taxes are specified as functions of the nominal gross domestic product, but customs revenue and grants are exogenous to the model. Government expenditures are made to depend on real GDP and total government receipts, and the government budget balance is determined as the difference between total government receipts and expenditures. Total receipts of government comprise direct and indirect taxes, customs revenues and grants and other non-tax revenues.

The **external** sector uses a set of identities to capture the major accounts in the balance of payments. The trade balance is the sum of the goods balance, the services balance and the incomes balance. The current account balance is the sum of the trade balance and the current transfers. The overall balance is defined as the sum of the current account and capital account balances and errors and omissions and valuation adjustments, where the capital and financial balance, errors and omissions and valuation adjustments are exogenously determined.

The model uses annual time series data spanning from 1980 to 2004, mainly sourced from Central Bank of Lesotho, Lesotho Bureau of Statistics and IMF's International Financial Statistics. The Engle-Granger two-step procedure is the technique used for estimation (E-views software used) in the model.

The Scenario and the Results

Following on from the previous section we have simulated a situation where the customs revenue available to Lesotho reduces by 14 percent from what it otherwise would have been. This is then modeled and results are presented as percentage deviations from the base initially forecast from 2004 through to 2009 on selected macro variables. The data calculated in the previous section suggested an 11 percent reduction, but we have increased this as concurrently with these changes the South African imports from SACU are displaying a large importation of diamonds from Botswana and Namibia that has not been in previous South African global import data and we hypothesize that this change will reduce Lesotho's share of the Custom's revenue from its present 12.18 percent to 9.6 percent.

The future paths of selected variables, or base case, are shown in Table 3a, while the new values of these same variables are shown in Table 3b. All values are expressed in million Maloti,³¹ and where:

TOTREC is an identity representing total government receipts;
GOVBAL is an identity representing government budget balance;
TOTGOVEXP is an endogenous variable representing expenditure;
RGDE is an identity representing real gross domestic expenditure;
NCAB is an identity representing the nominal current account balance; and

³¹ Where the South African Rand and Lesotho's Maloti are interchangeable.

BOP is an identity representing the balance of payments.

Table 3a: Base Forecasts to 2009						
	2004	2005	2006	2007	2008	2009
TOTREC	4,261.9	4,738.3	5,157.2	5,669.6	6,265.1	6,942.8
GOVBAL	221.5	295.0	266.7	314.7	405.9	530.9
TOTGOVEXP	4,032.2	4,440.5	4,888.5	5,355.9	5,859.9	6,412.0
RGDE	6,538.1	6,699.2	7,569.1	7,928.8	8,144.2	8,366.9
NCAB	-1,870	-1,542	-2,723	-3,122	-3,619	-4,213
BOP	-1,601	-1,173	-2,273	-2,531	-2,963	-3,486
Table 3b: Change In Customs Revenue						
	2004	2005	2006	2007	2008	2009
TOTREC	4,001	4,454	4,847	5,332	5,897	6,541
GOVBAL	-39.6	72.2	72.9	143.1	250.3	385.9
TOTGOVEXP	4,032	4,379	4,772	5,189	5,647	6,55.3
RGDE	6,548	6,671	7,520	7,864	8,067	8,281
NCAB	-1,870	-1,487	-2,633	-3,001	-3,469	-4,034
BOP	-1,601	-1,118	-2,182	-2,410	-2,813	-3,307

From Tables 3a and b, Table 4 expresses these changes in percentage deviations from the baseline.

Table 4: Changes from a reduction in customs revenue expressed as %						
	2004	2005	2006	2007	2008	2009
TOTREC	-6.1	-6.0	-6.0	-5.9	-5.9	-5.8
GOVBAL	-117.9	-75.5	-72.7	-54.5	-38.3	-27.3
TOTGOVEXP	0	-1.4	-2.4	-3.1	-3.6	-4.0
RGDE	0	-0.4	-0.7	-0.8	-0.9	-1.0
NCAB	0	3.6	3.4	3.9	4.1	4.2
BOP	0	-4.7	-4.0	-4.8	-5.1	-5.1

The interpretation is that from a sustained reduction in customs revenue we get a:

- Reduction in government expenditures in the next period and subsequent periods;
- Government budget moves into deficit in 2004 but subsequently shows a smaller surplus;
- Small reduction in gross domestic expenditures; and
- Gradual improvement in the balance of payments.

It is the sustained reduction in total government expenditure (rising to 4% by the end of the period) that is the major concern. This will feed through into a smaller reduction of 1% in gross domestic expenditure. This outcome would be even worse if some of the adjustment were not accommodated by a reduction in the projected budget surplus.

Policy Implications

It should be noted that the fiscal outlook remains sound as the projection indicates a sustained budget surplus. However, this is largely dependent on the continued underperformance of capital expenditure. If capital projects were implemented to their full appropriation, a fall in total revenue would force government to borrow more. This is likely to be a problem for fiscal prudence because in the recent past government committed to borrowing on concessional terms only, in order to reduce external debt and avoid borrowing on commercial terms from domestic capital markets. However, it is observed that in 2005 government has started to borrow on commercial terms with loans from (IFC) International Financial Corporation. Though this is not conclusive, it may be an indication of either creeping pressure on the fall on revenue, or anticipation thereof.

If commercial borrowing is necessary, the situation will be worrying because historical analysis indicates that Lesotho's financial position has always been worsened by borrowing on commercial terms, which is why government had to declare that loans should be on concessional terms only. This strategy has paid off as measures of debt sustainability have improved. However, if Government is forced to borrow domestically, this will reverberate through the economy and eventually, all things being equal, result in higher interest rates. Alternatively, Government may try to offset the negative impact on the fiscal balance by imposing further reductions in spending or increases in other taxes.

The major challenge that the government faces in this scenario will be achieving a sustainable reduction in public expenditure. There are numerous cost-drivers that are likely to create upward pressure on expenditure, including conversion of the pay-as-you-go civil service pension scheme into a funded scheme, and the need to implement expenditure programmes as part of the poverty reduction strategy in order to achieve the Millennium Development Goals. Government has also introduced a new program of Public Private Partnership (PPP) as a driver for development. This strategy is being adopted by countries world wide but, since the private sector in Lesotho is small, the government will have to guarantee most of the loans that the private sector will undertake under the arrangement in order to ensure that this initiative is successfully introduced and maintained.

The simulation results show that there will be a decline in gross domestic expenditure implying a decline in investment as private sector development in Lesotho lags government investment by about three years. Therefore a fall in government investment will lead to a fall in private investment and investor confidence. The capital expenditure in Lesotho is mainly donor funded and with the likely fiscal indiscipline donors are likely to hold back, thus exacerbating the problem as government may not be able meet its counter-part contribution that is mandatory under donor funded development.

The adverse impact shown in this simulation would be greatly exacerbated if it were combined with a downturn in Lesotho's existing export sector. The government is currently engaged in the private sector development strategy with the technical assistance of the World Bank, an initiative which seeks to diversify away from the current narrow base of textile and clothing exports to the US market into tourism, sandstone and horticulture. There is however a blind spot of how current international trade negotiations that Lesotho is engaged in will help to enhance benefits from

these initiatives. We hope that this paper alerts policy makers to the potential impacts of SACU trade preference agreements upon Lesotho's economy.