A note on the SADC economics of trade agreement

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1. Introduction

Recent years have seen a growing trend towards regional integration around the world. To this date, the WTO lists as much as 227 regional trade agreements (RTAs): while the great majority has geographically diversified signatories, only one fifth are intra-regional. Sub-Saharan Africa (SSA) is characterized by several regional economic communities (RECs) with an overlapping membership: Angola and D.R.Congo belongs to three RECs, namely ECCAS, COMESA and SADC. More over, nine countries have a membership with COMESA or SADC, the two biggest RTAs in SSA (see figure 1)[1].

South African Development Community (SADC) is one of the most important African regional trade agreements (RTAs), with respect to country membership, population and regional GDP (see table 1). Indeed, more than one third of the Sub-Saharan population lives in the SADC, whose economy accounts for nearly the half of the SSA's GDP. Among its 15 member states, six are middle income economies, with South Africa, the only African country among the G-20, playing an important role. It is not only the African region where it is easier to do business, but also it offers the lowest simple average

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1. As noted by Draper (2007), overlapping membership can be problematic, particularly in case of conflicting integration processes. It may be also associated with weak commitment.

Table 1: Major African Regional Trade Agreements: Selected Indicators (2009)

	Membership	Population (millions)	GDP (billions $US, current)	Simple Average Applied MFN Tariffs (2006-2009)	Ease of doing Business (1-183 worst)
Sub-Saharan Africa	49	842.0	914.7	11,4	137,9
CEMAC	6	41.0	61.8	17,1	173.2
COMESA	19	441.0	454.6	11,5	125.4
EAC*	3	116.3	67.7	11,8	116.2
ECOWAS	15	295.3	276.1	11,2	152.9
WAEMU	8	94.8	67.6	11,1	165,0
SADC	15	270.4	422.5	9,5	109.9

Sources: UNCTADstat and World Bank.

*In fact, EAC is made of 5 member states. Here Rwanda and Burundi, which joined EAC in 2007 are excluded.

"Most Favoured Nation" (MFN) tariff.[1] Although SSA attracts little FDI (43.3 millions in 2009), more than the half goes to SADC (24.3 millions).

To ensure its members adhere to their trade commitments, SADC has developed several institutional arrangements. In particular, Part 9 of the SADC Protocol on Trade sets up rules for dispute settlement. This mechanism is supposed to be an important instrument for SADC trade effectiveness (see Busch and Reinhardt (2004), Schwartz and Sykes (2002) in the WTO case). Alike the WTO rules, SADC Protocol on Trade provides for cases where a country can breach its obligations (see articles X on Security exception, XIII on Cooperation in customs matters, or XX on Safeguard measures for examples). It is interesting to examine these features in the light of economic theory.

The purpose of this paper is to draw a portrait of SADC as a RTA, in the light of the economics of trade agreements. To our knowledge, no study on SADC has taken this approach. The rest of this article is organized as follows: section 2 analyzes the benefits and challenges of creating a free trade area (FTA). In section 3, we briefly talk about the dispute settlement mechanism (DSM) which is an important institutional arrangement. Section 4 examines SADC RTA as an incomplete contract and raises some warnings how to efficiently limit abuses. In the light of observations made through our study, we conclude in section 5 with few recommendations.

2. Why a FTA for SADC?

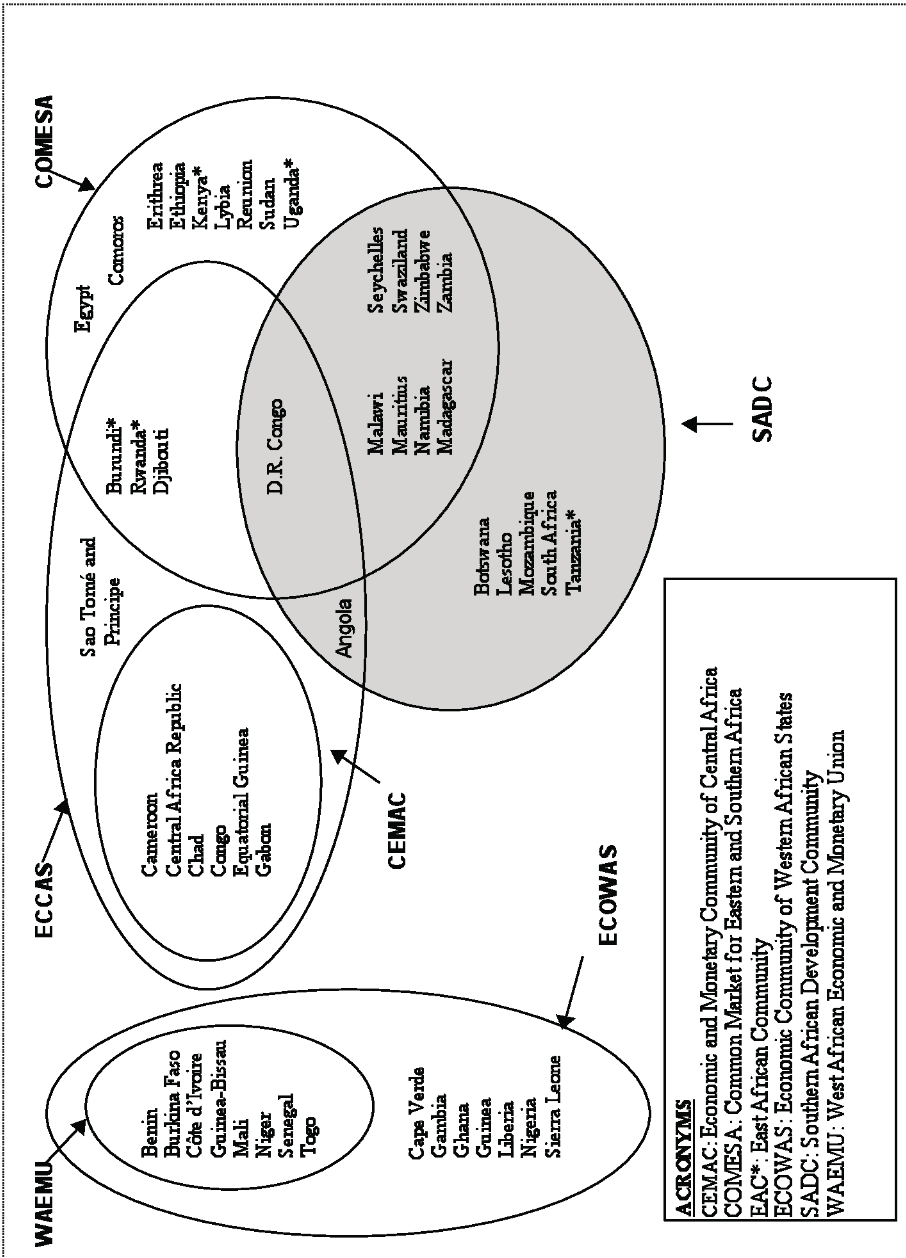
The creation of a FTA in 2004[2] is the first step toward SADC economic integration[3]. A regional economic integration (REI) is desirable because it can foster economic growth and employment, but also lower production costs, through economies of scale amongst

1. The World Bank has developed an indicator "Ease of Doing Business" (1-183 worst), representing a country's overall business climate based on seven indicators, three of which are also reported in the WTI database: Starting a Business, Enforcing Contracts, and Closing a Business.

2. August 02, 2004 is the date when SADC FT was notified to the WTO.

3. Economic integration refers to any type of arrangement (free or preferential trade agreement, customs union, common market, economic union or monetary union) in which countries agree to coordinate their economic policies (fiscal, monetary or/and trade).

Figure 1: Major African RTAs and its members *



Source : IMF, WTO

* This figure does not include IOC (Indian Ocean Community), WAMZ (West African Monetary Zone), SACU (Southern Africa Customs Union).

tiny markets, thus leading to better consumer prices.

However, research in the area of the "New Economic Geography (NEG)" advances arguments against REI among poor developing countries (Coulibaly and Fontagné, 2006; Deichmann and Gill, 2008). In fact, NEG predicts that a free trade area (FTA) will be detrimental to the majority of poor economies of the region, as industrial activity will tend to relocate to the middle incomes economies such as South Africa, fostering industrial concentration. In addition, being part of a FTA, poor countries hurt by the industrial relocation will also suffer from trade diversion by importing relatively expensive goods from the growing industrial centre rather than more efficient global producers, thereby reducing their overall welfare. Meanwhile, countries such as South Africa will benefit from the regional industry relocation, inducing real wage increases. Obviously, if materialized, these consequences would lead to substantial political pressures over time, jeopardizing SADC regional integration process. Moreover, trade diversion may occur, making poor economies worse off. Section 1.1 explains how a free trade agreement induces both trade diversion and trade creation.

2. 1. FTA and trade diversion/creation

Using a partial equilibrium framework, we analyze effects of a free trade agreement (FTA). We consider three countries: a small economy – let say, D.R.Congo (DRC), and two bigger ones (South Africa (SA) and the European Union (EU).

Figure 2.a depicts supply and demand of a particular good in the small country, DRC. P^{SA} and P^{EU} represent free trade supply prices of the good from SA and the EU: as, $P^{EU} < P^{SA}$, DRC will import the good from the EU and initially, no exchange will take place with SA. This results hold also if a same ad valorem tariff τ is applied on both goods ($\tau = P_\tau^{SA} - P^{SA} = P_\tau^{EU} - P^{EU}$).

We next assume that SA and DRC form now a FTA and DRC eliminates the tariff on imports from SA. Thus, prices prevailing on DRC market will be: P^{SA} and P_τ^{EU}, with $P^{SA} < P_\tau^{EU}$. In this case, SA will supply the DRC market with the traded good (import is given by $D^{SA} – S^{SA}$), while EU experiences a loss of market share, even though EU is more efficient at producing the traded good (its free trade price is lower). In other words, trade has been diverted from the EU to the benefit of SA[1].

In terms of welfare effects, DRC experiences an increase of consumer surplus (A + B + C + D), a reduction of producer surplus (- A) and government revenue (-(C + E)). The net effect on national welfare is uncertain and depends on the magnitude of these three effects. However, as small and poor developing countries heavily rely on tax revenues, a compensation mechanism should be designed to compensate them for loss of income.

Figure 2.b describes the case where a FTA generates trade. This is particularly relevant for SADC, because trade between its members is generally very low. Then, assume figure 2.b represents DRC home market. In autarky, supply (S) equals demand (D) at the price $P^{autarky}$. The later price level is smaller than P_τ^{SA} and P_τ^{EU}. Assume now that DRC removes its

1. SA can certainly benefit from trade diversion while a small and poor economy such DRC will not take advantage of this because of supply constraints.

Figure 2 a

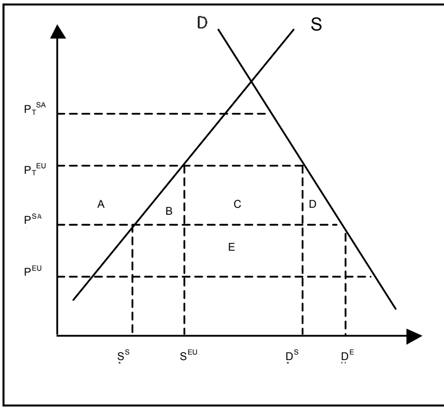
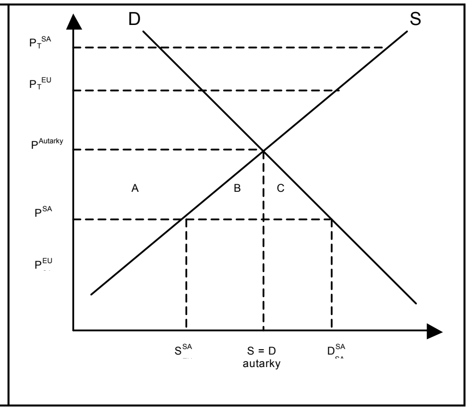


Figure 2 b



tariff applied on SA imports, after both countries form a FTA. Therefore, P^{SA} will be smaller than both $P^{autarky}$ and P_τ^{EU} ($P^{SA} < P^{autarky} < P_\tau^{EU}$). Thus, the creation of a FTA creates trade between SA and DRC. In terms of welfare, there is an increase of consumer surplus (A + B + C), but a reduction in producer surplus (- A). The net welfare effect is positive (+ (B + C)).[1]

Home producers will be hurt in face of more competitive foreign producers. This can lead to a relocation of production in SA and a rise in unemployment in DRC. Losers from a FTA might organize themselves and form interest groups to oppose more economic integration if they are not compensated.

This simple analysis framework helps us draw interesting lessons for policy coordination. In section 2.2, we explain why, despite trade diversion and loss of government revenue, a SADC FTA is desirable and what is needed to make it work for all its members.

1. Assuming prohibitive initial tariffs, leading to no imports, there is no initial tariff revenue; thus the FTA does not cause any loss of revenue in our example.

2. 2. Making SADC FTA profitable to all its members

Assuming country members' awareness of the risks attached to REI, what can motivate them to go forward with this process? It is well-known that increased trade between neighbors drives economic growth (Krugman, 2007). But this requires strategies such as a geographic distribution of economic activities among and within member states, following local comparative advantage. Miller (2010) identifies five sources of comparative advantage namely created assets-educated workforce, research, intellectual property, business infrastructure and physical infrastructure. Most of SADC lack much of them; however, some countries have taken step to build physical infrastructure. This is the case of DRC, with the "5 chantiers" programme, as well as Angola whose infrastructure is partly being financed through China-Africa cooperation. Beside this, FTA has the potential of trade creation among country members, which is welfare enhancing.

According to Bagwell and Staiger (2010), countries jointly lower trade barriers in order to increase their commercial relations, in manner to keep terms-of-trade unchanged. They note that, in absence of such agreement, each country has an incentive to unilaterally raise its tariffs: this results in an improvement on its terms-of-trade, while deterring those of the trading partner. If any two trading countries follow this strategy, they both end up with lower trade and reduced welfare. Thus, a trade agreement provides trading partners a solution to a terms-of-trade-driven prisoners' dilemma through. Simply put, a FTA allows countries to lower their trade barriers (notably tariffs), and at the same time to increase their commercial exchanges.

Does this theory hold for SADC? To answer this question, we need to compare trade volume among countries belonging to Southern Africa Customs Union (SACU)[1], on the one hand; and on the other hand, trade volume between SACU members and "outsiders" from SADC. Looking at trade in SACU, we find how South Africa (SA) is a cornerstone in that region: each SACU member trades more with SA than any other SADC country. We find that Swaziland's primary export destinations are SA (45 %) and Botswana (31.6 %), while two fifth of Lesotho total merchandise exports are destined to the SACU area, principally South Africa. SA (10 %) and Zimbabwe (8 %) are together the second destination for Botswana exports. Concerning Namibia, a proportion of 29 % of exports find their way in SA.[2] Concerning imports, SACU countries dependence towards SA is obvious: a proportion of 83.5 % in the case of Botswana and 92.9 % for Swaziland of goods and services purchased abroad originate from SA.

Looking at trade volumes, one can easily see that SA exports more in SACU than in other big SADC commercial partners: for example, exports to Botswana amount to $ 4.0 billion ($ 3.2 billion in Namibia), while trade with non-SACU members is lower (example: Zambia ($ 2.0 billion) or D.R.Congo ($ 1.1 billion)). Comparing Zambia to Botswana, both countries have approximately the same GDP level; the latter assuredly trade more with SA, thanks to their RTA. In the case of DRC, which is a bigger country than its SACU counterparts, it has a smaller trade, certainly because of the presence of trade barriers. Ceteris paribus, being part of a common RTA explains at least partially why they trade more with South Africa (see table 2). However, abstracting from the latter, SACU countries trade more with other SADC members than among themselves: for example, Namibia exports to Angola ($ 405.6 millions) are near 17 times higher than to Botswana, and more than half a thousand time higher than exports to Lesotho.

Being part of a customs union conveys some advantages to small countries like Botswana, Lesotho, Namibia and Swaziland. As they share a common external tariff, under the leadership of South Africa, they benefit from a revenue-sharing feature whereby South Africa subsidizes its partners. These countries have a revenue pool based on tariff collections. This arrangement is also present in WAEMU,

1. SACU membership is made of five countries, namely Botswana, Lesotho, Namibia, South Africa, Swaziland.

2. These proportions are for 2007 and are taken from Trade Policy Review WT/TPR/S/222/ZAF: Botswana, Lesotho, Namibia, South Africa and Swaziland (2009).

where leading economies, Ivory Coast and Senegal, collect three fifths of tariff income but keep only 12 percent for themselves and share the remaining with six other members. This teaches how compensating poorer countries is a key component of trade agreement. At the world level, developed economies have granted less developed countries (LDCs) "Special and Differential Treatment (SDT)"; the latter includes a privilege access to their markets, the right to keep high tariffs and non-reciprocity clauses. We believe the SADC should design a proper compensating mechanism to support weak economies of the region. Article XXVII of SADC Protocol on Trade § 1 allows the continuation of existing preferential trade arrangements, while § 2 opens the door to new ones. This is a very important issue, as tariff collection is a significant source of income for many countries of the region. In order to give up their tariff incomes, they need to get compensated. Another issue relates to economic dependence: as highlighted above, SACU countries economically depend on SA, that is the more developed economy of the region[1]. Thus, SA might heavily contribute to the revenue-sharing system, as its economy might benefit the most from removal of trade barriers. Indeed, it is well known in economic development that LDCs have supply constraints; these constraints have prevented most SSA countries to take advantage from SDT granted them by European Union. The latter has denied SDT to SA, considered as a competitive middle income economy.

SADC FTA supposes a real commitment by all members to give up some rights and reap benefits, mostly in terms of increased trade. Given supply constraints mentioned above, it can take some time before one reaps gains from enhanced cooperation; in order to dampen tensions that may arise among members and pressures in national political debates, SADC should conceive a well-defined compensation mechanism.

3. SADC DISPUTE SETTLEMENT

Commercial disputes are frequent among trading partners; SADC has established a tribunal where harmed countries can file a complaint for infringement. As in the WTO, the dispute settlement mechanism (DSM) makes only recommendations to parties and has no enforcement power. That supposes the plaintiff has a retaliatory capacity against the defendant; this capacity heavily rests on the threat to withdraw trade concessions valued by the defendant.

Concerning SACU, we believe not only their geographic situation, but also their dependency on South Africa economy, do not put them in a position to retaliate, should a conflict arise. Except Namibia and South Africa, all other SACU member countries are landlocked and depend on their neighbors for transit and sea access.[2 and 3] Moreover, how can

1. Small countries worldwide gain a lot from bigger trading partners, as they benefit from their neighbors' economies of scale in production of a large variety of goods and services. This helps them also to specialize and to import what they cannot produce efficiently, due to lack of market size.

2. Botswana shares a larger border with South Africa than with Namibia; thus, it can transit through both countries, while the other countries are landlocked within South Africa.

3. Article XV of SADC Protocol on Trade states freedom of transit within the Community. This shows how

one threat the hand that feeds it? Our opinion is supported by a growing literature on developing countries' retaliatory capacity in WTO dispute settlement: fear of reprisals, such as the removal of unilateral trade preferences, might prevent small countries from initiating a litigation process against their developed partners (Bush and Reinhardt, 2004; Davis and Blodgett, 2009). Bown (2004: 3) recognizes that "*developing countries may still be hesitant to bring formal complaints against trading partners on whom they are reliant for bilateral aid or other assistance*." In this case, SACU countries will avoid to be cut from the source of provisions to their citizens. Beside economic and commercial motives, the political dimension is important to understand SADC; its ancestor, the Southern African Development Coordination Conference (SADCC), was set up in pursuit of the Southern Africa political liberation from the apartheid.

SA has not such an important weight in all other SADC country members. Taking the example of D.R.Congo, its exports to SA represent only 0.2 % of this total exports and are worth $ 6.1 millions. But its SA imports, which amount to $ 1.1 billion, represent 29.8 % of its goods and services purchased from abroad.[1] This means that theoretically, when a trade dispute arises, DRC can threat to withdraw valuable concessions to SA in order to call the latter for compliance. In this latter case, a FTA induces significant tariff revenues to a country heavily relying on such source of income. Compensation mechanism requires also efficient collection, development and utilization of trade statistics. This poses a challenge, given feeble institutional capacities of most SADC members.

geography matters; we will develop more on that in the section on SADC integration.

1. DRC is the 4th importer of SA goods and services, following Zambia, Zimbabwe and Mozambique.

4. SADC trade agreement as an incomplete contract

A nascent body of literature considers international trade agreements as incomplete contracts; being such, this certainly applies to SADC. Article XX of the SADC protocol of trade, on Safeguard Measures, states that "*A Member State may apply a safeguard measure to a product only if that Member State has determined that such product is being imported to its territory in such increased quantities, absolute or relative to domestic production, and under such conditions as to cause or threaten to cause serious injury to the domestic industry that produces like or directly competitive products*." There is a lot of room for interpretation on what is "serious injury".

As noted by Maggi and Staiger (2010), international trade agreements have either vague provisions or are silent on some questions of interests that are subjects of disputes between trading partners. There are also cases that call for exceptions to the rule. In such cases, the SADC tribunal can play an activist role either by filling gaps when the law is silent, or by interpreting a vague provision. The tribunal can also allow exceptions to a well-defined rule under restrictive conditions. This happens because contracting at the international level is complex and there is a lot of uncertainty. Therefore, parties do not gain by specifying in advance their behaviour under every conceivable contingency. In such contracts, circumstances may arise in which it is in the joint interests of the parties for one of them to deviate from its commitments or "breach" the contract (Schwartz and Sykes, 2002).

This incompleteness of a trade agreement makes it attractive, as it prevents trade wars between signatories in a centrally administered sanctions system: a country can then deviate from its obligations without paying an excessive price (Sykes, 2009). For that purpose, article XXXII § 3 of the SADC Protocol of Trade restrains retaliation to the withdrawal of equivalent concession. The country member has to compensate its partners for the infringement: expected damages deter inefficient breach, as a country will refrain itself from breach if the compensation to be paid is higher than its gains from the breach, in which case breach is inefficient.

For all this to be effective, cooperation among members is essential, as prescribed by XXXII § 1. But practice does not always follow what has been agreed on paper. In 2010, Zimbabwe did not comply to a SADC tribunal ruling, that recommended the protection of the land owned by South African citizens. The ruling went against the agrarian reform and was judged "fundamentally contrary to the public policy of this country" (see SADC tribunal, case No 1 of 2010). This evidenced possible conflicting interests between international agreements and domestic policies. This case could have been an efficient breach if proprietors were offered compensations. This example shows how investment protection needs to be reinforced in order to attract FDI and thus bring regional growth.

5. Conclusion: SADC integration, an ongoing challenge

In this paper, we have examined how a FTA can enhance trade among SADC countries. We notice that small SACU countries trade more with South Africa (SA) than any other SADC member. The explanation lies partly on SACU RTA, but also on SA capacity to supply them with most goods and services they need. We believe FTA has the potential to increase trade at SADC level and bring prosperity; however, only few members will be able to reap these advantages, at least in the short run, given their supply constraints. South Africa, the leading economy of SADC, will benefit the most.

Hereafter are three recommendations to ensure the viability of SADC economic integration:

- SADC should establish a revenue-sharing system to compensate members for forgone tariff revenues. Large economies such as South Africa should be major contributors, as they are more suited to take advantage from economic opportunities created at the regional level.
- Regional discussions are unavoidable to address challenges stemming from geographic relocation of economic activities within the SADC. This creative destruction process is a potential source of national political tensions and resistance toward more regional economic integration (REI). Compensation mechanisms should be designed to ease economic transitions in different country members; thus, REI would not be perceived as a sum zero game.
- In order to attract foreign direct investment and thus overcome supply constraints they face, country members must commit to protect property rights

above national interests. In face of a reasonable exception, foreign investors should be compensated. To ensure members' adherence to this principle, a binding sanction mechanism should be designed.

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