

THE SUITABILITY OF A STABILISATION FUND FOR SACU

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EXECUTIVE SUMMARY

The most recent – 2002 – Southern African Customs Union (SACU) Agreement revised the customs and excise revenue sharing formula for SACU member states. Since this revision, some SACU member states have seen significant volatility in their receipt of revenues from the SACU revenue pool. Given this, one of the focus areas of SACU's work programme is the establishment of a regional SACU stabilisation fund, primarily to counter volatility in the common SACU revenue pool. This policy briefing summarises the rationale for and feasibility of such a fund in SACU.

A review of existing stabilisation funds finds no evidence of one established at a regional level. This may be because, at the very least, individual country participants would need to agree to a set of common regional fund deposit and withdrawal rules, which would impact their own revenue and expenditure dynamics.

For SACU, the establishment of a regional stabilisation fund is premised on the common SACU revenue pool being the root cause of the revenue unpredictability and volatility

POLICY RECOMMENDATIONS

- 1 A regional stabilisation fund is inappropriate and infeasible for SACU. SACU member states have historically faced different degrees of revenue volatility and unpredictability, and this volatility has emanated from different revenue sources. Agreeing on common stabilisation fund deposit and withdrawal rules that apply to all member states in such an environment would be especially difficult.
- 2 SACU member states must focus on revising and refining the existing revenue-sharing formula and process used to collect and distribute pool revenues. The SACU revenue pool is the only common source of member state revenue volatility and the current formula (and process) used to disburse revenues from the SACU pool is the underlying cause of volatility.
- 3 SACU member states can improve revenue and expenditure predictability through a range of country-level fiscal policy options. A country-level stabilisation fund is one such option. Implementing other fiscal instruments, including fiscal rules, medium-term expenditure frameworks, fiscal councils and contingency reserves, should also be considered.

for member states. However, an analysis of SACU member state revenues highlights that the scale and source of revenue volatility differ for each. Receipts from the common SACU revenue pool are the main drivers of overall revenue volatility only for Lesotho, Namibia and eSwatini (Swaziland).

The lack of historical precedent for a regional fund with a stabilisation objective – and the fact that SACU member states have significantly different revenue and expenditure profiles – demonstrates the potential difficulty in establishing a regional stabilisation fund for SACU. Where regional funds do exist, they are typically established for broader development and infrastructure investment purposes.

INTRODUCTION

WHY SACU IS EXPLORING THE ESTABLISHMENT OF A STABILISATION FUND

One of the main outcomes of the most recent SACU Agreement – in 2002 – was the implementation of a revised customs and excise revenue-sharing formula across SACU member states. However, some SACU member states have faced significant revenue volatility and unpredictability since this new formula's implementation in 2004.

Given this, a priority area in the work programme of SACU's Third Ministerial Retreat is the exploration of a SACU stabilisation fund. Ultimately, this is an effort to improve the predictability and reduce the volatility of member state revenues, especially in terms of member state receipts from the SACU revenue pool. Separately, exploring the possibility of a regional development or industrial financing mechanism also forms part of the current SACU work programme. This policy briefing focuses on the rationale for a stabilisation fund for SACU.

HOW STABILISATION FUNDS TYPICALLY OPERATE

Extra-budgetary funds (EBFs) in general can be defined as 'general government transactions, often with separate banking and institutional arrangements, that are not included in the annual state (federal) budget law and the budgets of subnational levels of government'.²

Revenue stabilisation or smoothing is one of many potential objectives that an EBF may aim to achieve. There is no single definition of a stabilisation fund, but the basic premise is to smooth (or improve predictability in) government expenditures and consumption by creating a buffer against negative external shocks to (or unpredictability in) government revenues.³ Through such an approach, greater predictability in government expenditure is expected to achieve better sustainable development outcomes.

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Given that such revenue shocks (and the ability to raise a revenue buffer) are particularly prominent in resource-rich economies, a stabilisation fund has also been described as a fund that is 'intended to smooth revenue streams from natural resources and bring more predictability into the country's budget'.⁴ Because of this link to commodity revenues, stabilisation funds have been closely tied to natural resource funds and sovereign wealth funds (SWFs).

SWFs often have a dual purpose: to smooth government revenues over time (or increase the predictability of government revenues, a budget stabilisation function) and to save resource revenues for future generations (a savings or 'heritage' function). In some cases, as funds' assets have grown, fund objectives have broadened beyond the narrow stabilisation or savings mandate to include wider sustainable development objectives, and to diversify economic growth away from a reliance on commodity resources.

One of the fundamental considerations in a stabilisation fund's design is the deposit and withdrawal rules that govern its financing and expenditure. Given that stabilisation funds have primarily been established in countries with substantial natural resource endowments, for many existing funds, deposit and withdrawal rules are linked to benchmark prices for commodities or

based on the level of government revenue extracted from commodity sales and exports. Deposit and withdrawal rules for some funds have also evolved as the fund's assets have grown, or as the government's revenue dynamics have changed. For these funds there is increasingly a closer integration with the government budgeting process, and the level of deposits and withdrawals from a fund is primarily determined by a fiscal policy guideline or 'rule'.

WHY A REGIONAL STABILISATION FUND MAY NOT BE APPROPRIATE FOR SACU

A STABILISATION FUND AS A SUB-OPTIMAL POLICY INSTRUMENT

In many cases EBFs are not a necessity to fulfil a specific economic or financing requirement. However, EBFs may nevertheless be established to address budget system and political factors that weaken the link between government revenues and expenditure.⁵ Thus, EBFs may aim to contribute to selective sustainable

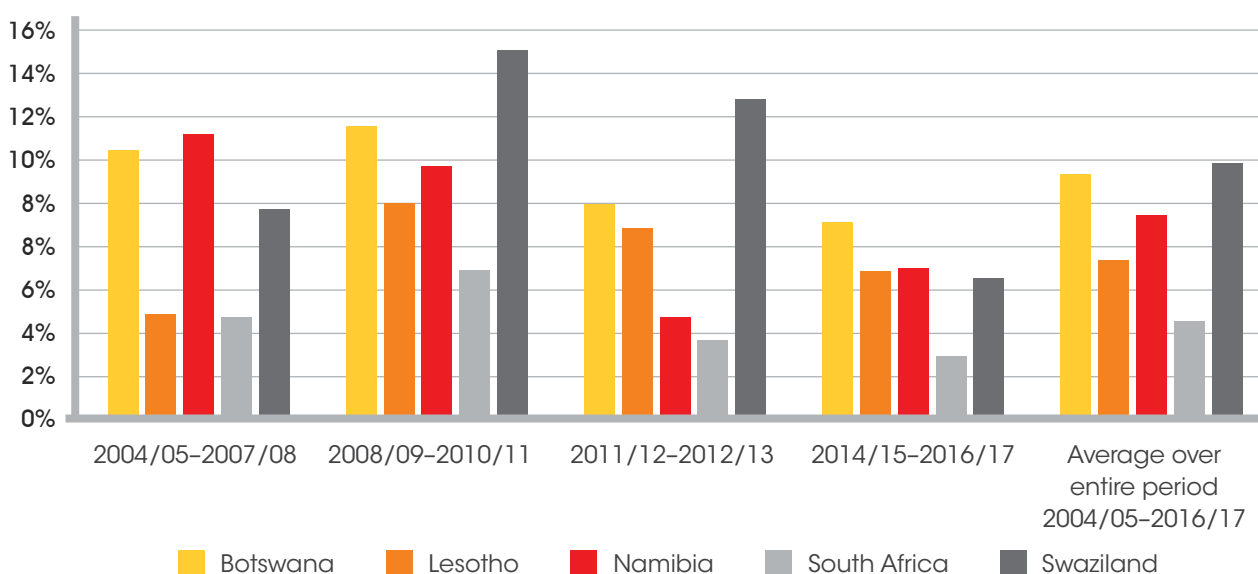
development objectives by insulating specific revenue streams and funds from the overall budgeting process.

Similarly, a stabilisation fund cannot substitute for good fiscal policy. There is often little economic rationale for the establishment of a stabilisation fund over the use

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of other fiscal instruments.⁶ That is, from an economic perspective the objective(s) of a stabilisation fund can be achieved without actually creating a stabilisation fund. Rather, a stabilisation fund is often established to compensate for weak governance and/or political economy factors, including the need to create relatively

FIGURE 1 ABSOLUTE % DEVIATION FROM TREND REVENUE (AVERAGE)



Source: Own calculations based on data from country ministries of finance and central banks

autonomous institutions that can be insulated (to some extent) from weak budgeting and fiscal policies.⁷

DIFFERENT SCALE AND SOURCES OF REVENUE VOLATILITY FOR SACU MEMBER STATES

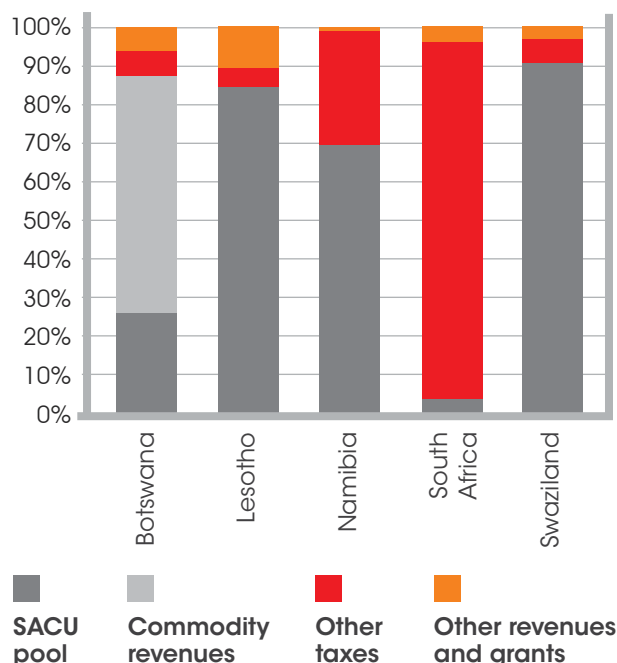
The use of a stabilisation fund has, in practice, been premised on the smoothing of volatile revenue resources to ensure greater predictability in government expenditure. However, an analysis of SACU member state revenues shows that the overall level of revenue volatility is markedly different across SACU member states.

This is highlighted in Figure 1, which shows the percentage deviation of each member state's total revenues from the long-term trend. Over the entire period (2004/05–2016/17), South Africa has experienced far lower volatility than other SACU member states. South Africa's overall volatility is less than half that experienced by eSwatini, which has the highest level of volatility among all SACU member states. Botswana's level of volatility is also comparatively high, while Lesotho's level of volatility over this period is substantially lower than that of Botswana, Namibia or eSwatini.

The sources of revenue volatility are also different for each SACU member state. Figure 2 shows the estimated contribution of each revenue stream to total revenue volatility (using variance as the metric) for each SACU member state. For Lesotho and eSwatini, the volatility in SACU pool revenues is the main contributor to overall revenue volatility. For Namibia, while the SACU pool is also the main contributor to overall revenue, other taxes also drive volatility in its overall revenues. In South Africa's case, other (internal) taxes (such as income taxes and taxes on good and services) are the main driver of revenue volatility. For Botswana, the main source of revenue volatility is in fact commodity revenues.

While the exploration of a regional stabilisation fund for SACU is premised on volatility emanating from the SACU pool, it is clear that this source of volatility does not affect each member state to the same degree. It is also clear that improving revenue predictability (and reducing revenue volatility) is not an equally important policy priority for each SACU member state.

FIGURE 2 CONTRIBUTION TO TOTAL REVENUE VARIANCE (2004/05–2016/17)



Note: For illustrative purposes, the covariance between revenue streams (ie, the level of co-movement between revenue sources that contributes to overall revenue volatility) is not shown in the graph. Including the covariance between variables does not substantively change the analysis

Source: Own calculations based on data from country ministries of finance and central banks

NO PRECEDENT FOR A REGIONAL FUND WITH A STABILISATION OBJECTIVE

Given that many stabilisation funds have arisen out of the need to insulate domestic budgets from domestic resource revenue volatility, it is not surprising that there is no evidence of regional, multi-country stabilisation funds. Were a multi-country stabilisation fund to be established, it would likely require that country participants in the fund adhere to an 'external' set of rules regulating when they make deposits into the fund and when the fund can be accessed to support a country's fiscal policy. The political and policy need for fiscal independence makes such an arrangement unappealing for country governments that wish to maintain a sovereign hold on fiscal matters.

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While regional development funds do exist, these funds operate without directly imposing fiscal rules or limitations on country budgets, making the institutional and regulatory structure much simpler. At the same time, a less formal, more discretionary regional stabilisation fund is likely to weaken its effectiveness.

POLICY OPTIONS TO ADDRESS REVENUE VOLATILITY

COUNTRY-LEVEL OPTIONS FOR ADDRESSING REVENUE VOLATILITY

The implementation of a country-level fund is one of a number of policy options to address revenue (and expenditure) volatility and unpredictability. Various other 'special fiscal instruments' have been highlighted in the literature as potential tools in addressing budget and government expenditure predictability and reducing volatility. These include:⁸

- medium-term expenditure frameworks: the adoption of a medium-term budget outlook, with stronger linkages between annual budgets, policy goals and medium- to long-term fiscal objectives;
- fiscal rules: legally binding numerical targets for, or ceilings on, budget aggregates, such as expenditure ceilings or expenditure growth targets, balance budget rules or public debt to gross domestic product ratios (a recent International Monetary Fund study advocates for the implementation of such rules to address budget unpredictability and volatility in Lesotho and eSwatini);⁹
- fiscal councils: executive or legislative bodies that are responsible for an independent assessment of fiscal policies, plans and performance, and that aim

to foster greater transparency and accountability in fiscal policy; and

- revenue earmarking: legislatively assigning revenue from specific taxes or revenue to specific expenditure areas or activities.

SACU member states could also use contingency reserves to act as a revenue buffer when government revenues are substantially lower than forecast owing to exogenous shocks.

ADDRESSING VOLATILITY FROM THE SACU REVENUE POOL

Revenues from the SACU pool comprise customs and excise revenue collected by all SACU member states, which is pooled prior to distribution based on a formula agreed to under the 2002 SACU Agreement. Between 2005/06 and 2016/17 a combined total of approximately 19% of pooled excise revenues was distributed to Botswana, Lesotho, Namibia and eSwatini (BLNS). During this period, roughly 83% of pooled customs revenues were distributed to the BLNS.¹⁰

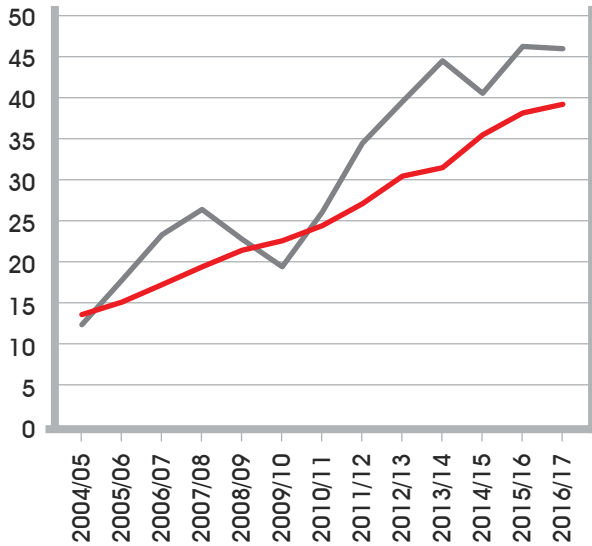
The causes of revenue volatility from the SACU pool revenues are twofold. First, the structure of the formula used to distribute pooled revenues entitles BLNS member states to a much larger proportion of (inherently volatile) pooled customs revenues than they actually collect. Ultimately, the rationale for this is based on an implicit agreement that the BLNS should be compensated for conforming to South African trade and industrial policy.¹¹

The inherent volatility of the customs component of the SACU pool is shown in Figure 3, which provides a summary of the total collections that have contributed to the SACU pool between 2004/05 and 2016/17. Customs collections have been substantially more volatile (measured as deviation from the historical trend) than excise revenues.

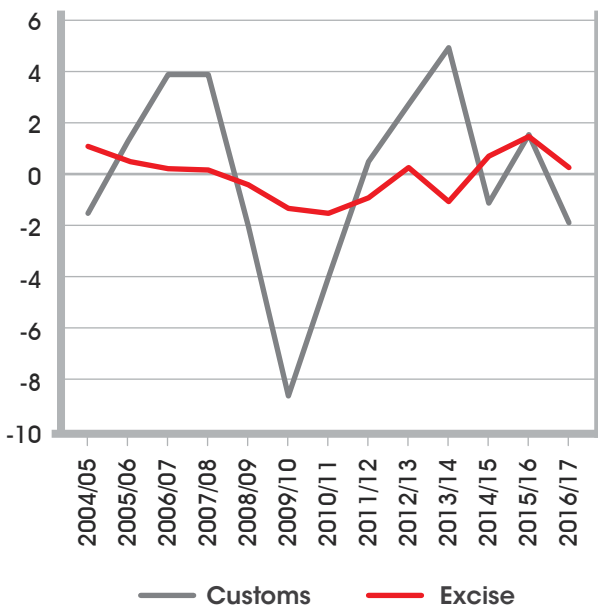
As a result of the formula for revenue distribution, a large portion of the customs pool revenues distributed to the BLNS is based on the collection of taxes raised on goods that are imported by South Africa. This is highlighted in Figure 4, which shows member states' shares of extra-SACU imports (ie, those imports that attract import duties) and of the customs component

FIGURE 3 VOLATILITY IN SACU REVENUE POOL COLLECTIONS

CUSTOMS AND EXCISE COLLECTIONS FOR SACU REVENUE POOL (ZAR BILLION)



DEVIATION FROM TREND (VOLATILITY) IN SACU REVENUE POOL COLLECTIONS (ZAR BILLION)

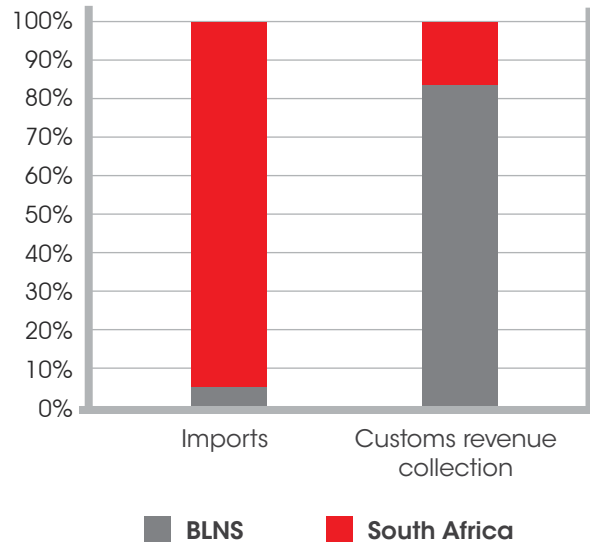


Note: The exchange rate at the time of writing was ZAR 13.40/\$1.00

Sources: Own calculations based on data from National Treasury, 'Budget Reviews, 2005/06–2017/18', <http://www.treasury.gov.za/documents/national%20budget/default.aspx>, accessed 23 July 2018

from the SACU revenue pool. Despite only accounting for an average of 5% of extra-SACU imports between 2011 and 2016, the BLNS member states received, on average, 83% of customs revenues that were collected in SACU.

FIGURE 4 COMPARISON OF MEMBER SHARES OF EXTRA-SACU IMPORTS AND SACU CUSTOMS



Note: Trade data for annual years is compared to customs data for fiscal years, eg, annual 2011 trade data is compared to customs revenues for the 2011/12 fiscal year

Sources: Own calculations based on data from National Treasury and ITC (International Trade Centre), Trade Map, <https://www.trade-map.org/>, accessed 23 July 2018

Because of this, any shocks to South Africa's trading (import) conditions have a magnified impact on BLNS government revenues. In addition, as the SACU revenue pool (and specifically, the customs component of the pool) makes up a comparatively small share of South Africa's total revenues, an inaccurate estimate of customs collections does not create significant budgetary or fiscal uncertainty for South Africa. By comparison, because the customs component is the biggest contributor to the BLNS' share of the SACU pool, and because the SACU pool is a significant proportion of BLNS government revenues (especially for Lesotho, Namibia and eSwatini),

these countries experience a greater degree of overall revenue volatility owing to receipts from the SACU pool.

The unpredictability and volatility of SACU pool revenues for the BLNS can therefore only be addressed if SACU member states agree on a revised revenue-sharing arrangement that does not directly link such a large proportion of each member's share of pooled revenues to customs collections.

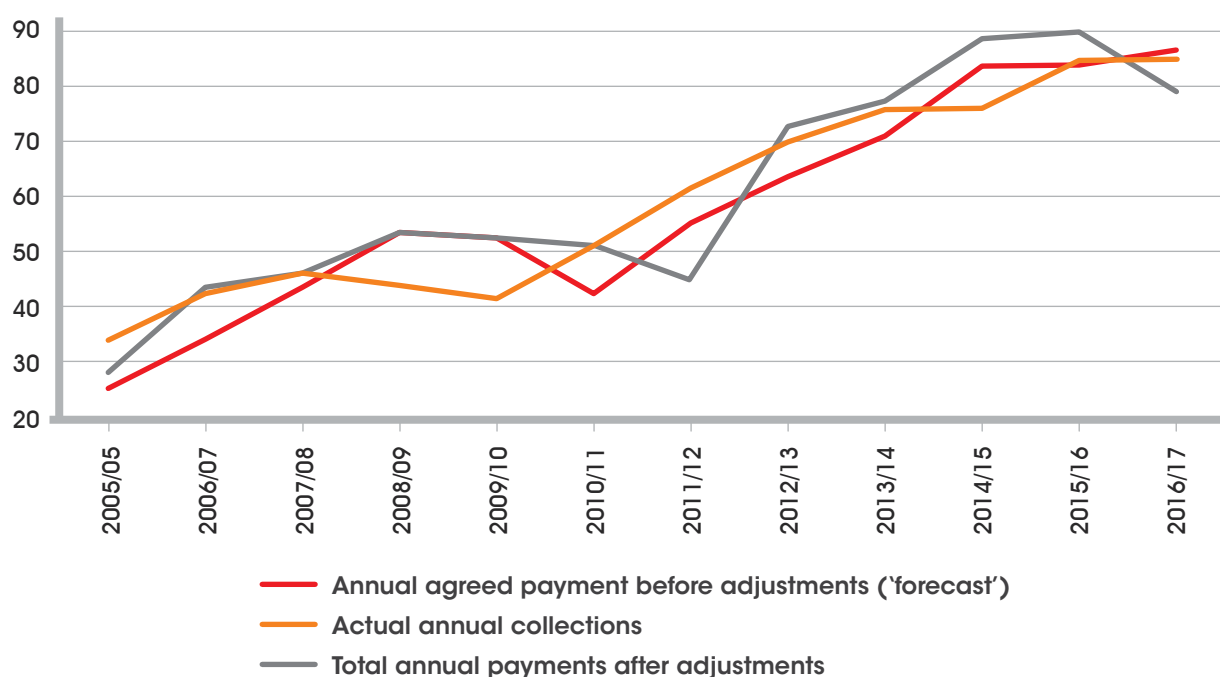
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The second cause of revenue unpredictability in the SACU pool receipts is the process used to distribute SACU pool revenues. This process creates uncertainty, as a number of adjustments are made that weaken the link between projected (forecast) disbursements, annual collections and actual annual payments. This arises because of annual timing and forecast adjustments made to actual payments from the SACU pool, as well as because of ad hoc adjustments that are made to payments to each SACU member state.

These payment adjustments both create uncertainty in SACU member states' budgeting processes and weaken the link between actual annual revenue collections and actual payments from the SACU pool. This is reflected in Figure 5.

There are consistent and substantial differences between projected payments, actual collections and actual payments over the entire period. For example, in 2011/12 the total actual SACU pool revenue collection was 35%

FIGURE 5 SACU POOL REVENUE FORECASTS, COLLECTIONS AND PAYMENTS (ZAR BILLION)



Note: The exchange rate at the time of writing was ZAR 13.40/\$1.00

Sources: Own calculations based on data from National Treasury, 'Budget Reviews', 2005/06–2017/18, <http://www.treasury.gov.za/documents/national%20budget/default.aspx>, accessed 23 July 2018; SARS (South African Revenue Service), 'Tax statistics, 2008–2017', <http://www.sars.gov.za/About/SATaxSystem/Pages/Tax-Statistics.aspx>, accessed 23 July 2018; SACU Secretariat, 'Annual reports, 2004/05–2016/17', <http://sacu.int/list.php?type=Annual%20Reports>, accessed 23 July 2018

(ZAR 16 billion [\$1.2 billion]) higher than the actual total annual payments made, while actual payments were 18% (ZAR 9.9 billion [\$739 million]) lower than forecast for that year. The current process for sharing SACU pool revenues clearly adds to the unpredictability and uncertainty of an already volatile source of revenue.

To address these process issues and bring more certainty to the budgeting and forecasting process for SACU member states, several possible solutions have been highlighted in the literature. These include:¹²

- adjusting the process for determining distribution by making the forecast the final determinant of distribution, rather than having an additional adjustment process;
- moving to an ‘instantaneous’ pay-as-you-collect system, which would reduce uncertainty over the medium term; and
- spreading the adjustment process over a wider number of years to alleviate the once-off shock impact.

A mechanism to smooth disbursements from the pool over subsequent periods could also be implemented, and could operate (in principle) in a manner similar to the adjustment processes used in many countries for fuel price smoothing.¹³

It is important to reiterate, however, that only a complete review of the revenue-sharing arrangement would address the core causes of revenue volatility in the SACU revenue pool, especially for the BLNS.

ENDNOTES

- 1 Yash Ramkolowan is an Economist and Manager of DNA Economics’ Trade and Integration Practice. He has been involved in many of DNA’s of trade policy research activities across Southern Africa.
- 2 Allen R & D Radev, ‘Extrabudgetary Funds’, IMF (International Monetary Fund), Fiscal Affairs Department. Washington, DC: IMF, June 2010.

- 3 Wagner G & E Elder, ‘The role of budget stabilization funds in smoothing government expenditures over the business cycle’, *Public Finance Review*, 33, 4, 2005.
- 4 Bagattini G, ‘The Political Economy of Stabilisation Funds: Measuring their Success in Resource-Dependent Countries’, IDS (Institute of Development Studies) Working Paper, 356. Brighton: IDS, 2011.
- 5 Allen R & D Radev, *op. cit.*
- 6 Bagattini G, *op. cit.*
- 7 *Ibid.*
- 8 Ossowski R & H Halland, ‘Fiscal Management in Resource Rich Countries: Essentials for Economists, Public Finance Professionals, and Policy Makers’. Washington, DC: World Bank Group, 2016.
- 9 Honda J *et al.*, ‘Fiscal Rules: Coping with Revenue Volatility in Lesotho and Swaziland’. Washington, DC: IMF, Africa Department, 2017.
- 10 Own calculations based on data from National Treasury. This is before any ad hoc adjustments have been made to SACU pool distributions.
- 11 The appropriateness of the SACU revenue-sharing formula has been subject to numerous reviews and debate, while SACU itself has commissioned studies to address concerns. For public reviews, see, for example: Edwards L & R Lawrence, ‘SACU Tariff Policies: Where Should They Go From Here?’, CID (Center for International Development) Working Paper, 169. Cambridge, MA: CID, May 2008; Flatters F & M Stern, ‘Implementing the SACU Revenue-Sharing Formula: Customs Revenues’, National Treasury Policy Brief. Pretoria: National Treasury, 2005; Grynberg R & M Motswapong, ‘SACU Revenue Sharing Formula: The History of An Equation’, BIDPA (Botswana Institute for Development Policy Analysis). Gaborone: BIDPA, 2003.
- 12 Mongardini J *et al.*, ‘Building a Common Future in Southern Africa’. Washington, DC: IMF, 2013.
- 13 For an assessment of fuel pricing adjustment mechanisms see Coody D *et al.*, ‘Automatic Fuel Pricing Mechanisms with Price Smoothing: Design, Implementation, and Fiscal Implications’. Washington, DC: IMF, 2012. While investigating such an approach to the SACU revenue pool is beyond the scope of this study, this is not fundamentally different to a forecast-actual rule employed by some stabilisation funds.

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