

## **SADC Rules of Origin: Undermining Regional Free Trade**

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## **SADC Rules of Origin: Undermining Regional Free Trade**

### **Summary**

With a few exceptions, Sub-Saharan Africa has failed to benefit adequately from globalization. Following a decade or more of liberalization and policy reform, however, regional players are now becoming competitive in international markets. This promises new investment, employment growth and skill enhancement, all essential foundations of development.

SADC Member States have chosen regional integration as part of their strategy for global participation. While not a first best strategy, regionalism can complement more general trade and investment liberalization. Whether this happens will depend on the vision guiding regional integration – whether SADC is viewed as a small extension of protected domestic markets, or as platform for increasing the competitiveness of regional producers in world markets.

Unfortunately the SADC Trade Protocol is seriously flawed. Back-loaded and confusingly differentiated tariff reduction schedules are well-known problems. Less clearly understood are the effects of complex and restrictive rules of origin.

Rules of origin are required in order to *authenticate* that goods trading under SADC preferences actually are the result of economic activity in the region. SADC trade negotiators initially agreed on a simple and transparent set of rules for this purpose.

They later chose a different path, attempting to burden rules of origin with responsibility for a variety of goals that could be achieved better through other means, and to employ them as instruments of protection, thus undermining the principal goal of the Trade Protocol.

This change in direction in the use of rules of origin was the result of several factors including

- some fundamental misunderstandings of the economic impacts of rules of origin, and especially the way in which they decrease flexibility in sourcing of raw materials, a key determinant of competitiveness in international markets,
- capture by vested interests, and
- a general lack of commitment to trade liberalization.

As they are now, SADC rules of origin will hinder regional economic integration and, at best, have no impact on global competitiveness of regional producers. They will make SADC irrelevant for the most dynamic, internationally competitive manufacturers in the region. In many cases rules of origin have been designed to undo the trade creating effects of tariff liberalization.

These rules of origin should be a principal item on the agenda for the review of the Trade Protocol scheduled for 2004.

Without fundamental reform, SADC is doomed to economic irrelevance.

## **SADC Rules of Origin: Undermining Regional Free Trade**

### **1. Introduction**

With a few exceptions, most notably Mauritius, sub-Saharan Africa has not been a major supply side participant in international markets, especially for manufactures. However, a number of forces have come together to offer a new opportunity for the region, and especially for South Africa and other SADC Member States.

- Market deregulation, rationalization of tariff regimes, removal of policy-induced market distortions, and new competition policies and institutions have improved the investment environments in a number of countries. Southern Africa has become a more attractive place to invest – not just for sales to protected domestic markets, but as a base for competitive access to global markets. A surprising number of firms in previously pure import-substitution activities have become successful competitors in international markets. And new investments in a variety of sectors are being made with an explicit focus on export markets.
- In addition, the rules-based international trading framework embodied in the WTO has formalized improved access to world markets for all signatories, and especially for poorer countries. While many weaknesses remain, there is already a base of opportunities for countries in southern Africa. The planned dismantling of the Multi-Fibre Agreement in 2005 will remove major constraints and market distortions in this sector. Domestic policy reforms are a perfect complement to these changes in international regimes.
- Of most immediate and possibly greatest importance to southern Africa are special market access privileges being made available to the largest and most important markets in the world – those in the US and EU. In Europe, the Cotonou Agreement, the Economic Partnership Arrangements (EPAs) that are now under negotiation, the Everything But Arms Initiative, and the EU-South Africa free trade agreement all offer special access for a wide range of African exports. In the US, the Africa Growth and Opportunities Act (AGOA) provides an unprecedented expansion and extension of GSP privileges, with very few limitations or restrictions for a period of at least eight years to qualifying African countries, including most SADC Member States. In many respects AGOA is the greatest and certainly the most immediate opportunity facing southern Africa.

SADC Member States have chosen regional integration as part of their strategy for global participation. While not a first best strategy, regionalism can complement more general trade and investment liberalization. Whether SADC assists in taking advantage of the new opportunities depends on how the SADC Trade Protocol is actually implemented.

There are two quite different visions of SADC, and the policy directions chosen by Member States in implementing it will depend on which of these visions is felt to be appropriate (see Flatters 2001). The two visions and the alternate policy directions are well illustrated in the evolution of rules of origin.

- The first vision is of SADC as a fortress within which Member States can develop themselves through privileged access to an enlarged market area that remains protected from and relatively isolated from external markets. Seen in this way, the purpose of the SADC Trade Protocol is to extend the boundaries of protected domestic markets, while continuing to protect the region's underdeveloped sectors and industries from external competition.
- The second vision of SADC is as a platform for directly improving the competitiveness of individual Members in international markets. Regional integration is seen as part of a more general strategy for full and meaningful participation in global markets.

The vision that has driven the development of the SADC Trade Protocol has been distinctly inward-looking. Rules of origin and other Provisions of the Trade Protocol have been far more responsive to fears of external (international and regional) competition in domestic markets rather than by a desire to capitalize on opportunities for improving international competitiveness.

The rules of origin that were first agreed by SADC were simple, general and consistent with those in other developing country PTAs, including COMESA. Goods would qualify for SADC tariff preferences if they underwent a single change of tariff heading, contained a minimum of 35 percent regional value-added, or included non-SADC imported materials worth no more than 60 percent of the value of total inputs used.

Certain Member States then pressed for exceptions to these rules. The arguments for these exceptions were varied, but many of them boil down to attempts to increase protection in domestic markets. This has led to a rule of origin regime that is much different from what was originally agreed, characterized by 'made-to-measure' sector-specific rules that are far more restrictive than first agreed. The rules are now much more like those in PTAs with rich, highly industrialized countries, and similar to those in the EU-South Africa and EU-ACP trade agreements.

The current rules of origin are complex and restrictive. It is argued here that a continuation of this approach to rules of origin will seriously impede regional integration in SADC, even when tariff barriers on intra-SADC trade disappear. Furthermore, they will make SADC, at best, irrelevant in promoting the integration and competitiveness of SADC industries in the global economy. The review of the SADC Trade Protocol that is scheduled to take place in 2004 provides an opportunity to consider alternative approaches to rules of origin in SADC.

## 2. The Functions of Rules of Origin

Rules of origin can serve two functions in a preferential trading arrangement (PTA) such as SADC. The *first* is to ensure that non-members do not benefit from market access privileges intended only for members. This can be thought of as the *authentication* function of rules of origin. The *second* is to encourage certain regional activities or to protect them from potential competition arising from the formation of the PTA. This is the *protective* effect (intended or unintended) of rules of origin.

The first of these functions, authentication, is a necessity in any PTA.

Article 2 of the Trade Protocol identifies the enhancement of economic development, diversification and industrialization of the region as major goals. Some consider this to be counsel for protection as a development tool. There is considerable danger with this interpretation.

Under an inward-looking view of regional integration, rules of origin are seen as an instrument to promote development through import substitution—in particular, by forcing producers to source inputs in the region in order to qualify for regional trade preferences. The PTA is seen as an opportunity to expand the size of a protected market, and rules of origin are an element of a strategy to create a 'fortress-like' PTA, and promote regional development behind a variety of protective barriers.

According to the alternative 'open regionalism' approach, PTAs are seen as a platform from which the members can integrate successfully and increase their competitiveness in the world economy. The approach to rules of origin under this strategy is much different than that under the 'fortress' approach. In particular, it recognizes the importance of flexibility to source inputs internationally as well as domestically in order to promote investment and increase international competitiveness.

Regardless of where one stands on this issue, it is generally recognized that the greater the restrictiveness of rules required for authentication, the greater their protective effects as well.

## 2.1 Authentication: Prevention of Tariff Jumping

Rules of origin are required in any preferential trading arrangement (PTA) in order to determine whether goods entering the market of any member truly originate in the region, and hence qualify for preferential treatment. In the absence of some well-defined rule of origin, there is a danger that goods will enter the PTA through a low tariff member and then pass duty free into the market of a higher tariff member. This is often referred to as ‘tariff jumping’ or ‘trade deflection’. When external tariffs are low and/or relatively similar among Member States, the dangers of tariff jumping are minimal, and hence there is little need for rules of origin, especially strict ones.

The need for rules of origin increases with the height and variance of external tariffs among Member States. The desire for strict rules of origin is generally greatest in Member States that give high levels of protection to their domestic industries.

Most PTAs define a threshold level of local/regional processing or manufacturing within the region as a requirement for preferential treatment. The SADC Trade Protocol includes both general conditions stipulating that simple packaging, assembly and labeling, for instance, are insufficient to confer originating status (Rule 3 of Annex I to the Protocol), and specific rules for all chapters of the HS tariff code. The specific rules define either a minimum level of locally originating costs (or maximum levels of import content), or certain specific types of manufacturing or processing activity. See Box 1 for further information on Rule 3.

### 1. The Danger of Competition from ‘Screwdriver’ Assembly Industries

A frequently expressed concern of existing producers is that SADC free trade will foster ‘screwdriver’ or ‘pure assembly’ operations in neighboring countries that will become a source of unfair competition. Restrictive rules of origin, it is argued, will prevent this from happening. Whether this is a legitimate concern is discussed further below. If it were so, does the Trade Protocol need sector specific rules to deal with it?

Under the regulations of the SADC Trade Protocol, sector-specific rules of origin are unnecessary for this purpose. Rule 3 of Annex I to the Protocol provides a general list of assembly, packaging and mixing operations that are *not* sufficient to confer originating status for the purpose of preferential tariff treatment under the Protocol. Among the operations that are singled out as not conferring origin are: “packing, packaging and other preparations or processes for shipping and for sales”; “mere dilution, blending and other types of mixing”; and “simple assembly or combining operations.”

For each of these categories, the Protocol elaborates on the types of activities that are insufficient to confer origin. In addition, to avoid any further ambiguity and to prevent the use of subterfuges to avoid these prohibitions, it adds to the list of activities not sufficient to confer origin: “any process or work in respect of which it may be demonstrated, on the basis of the preponderance of evidence, that the sole objective was to circumvent these rules.”

Rule 3 ensures that the products of simple ‘screwdriver’ or pure assembly activities cannot qualify for SADC tariff preferences.

## 2.2 Protection

Rules of origin have another important effect, to protect particular industries, intentionally or unintentionally, from regional competition. This protection can be of two forms – preventing regional competition that might otherwise emerge as a result of regional trade liberalization, and encouraging regional production of intermediate products.

- Restrictive rules of origin deprive producers of access to raw materials or intermediate products from low cost international sources and hence can raise the cost of producing a

product for sale in the PTA.<sup>1</sup> They force them into production patterns and cost structures that impede their international competitiveness. Raising the costs of regional producers in this way can frustrate their ability to take advantage of regional preferences. Restrictive rules of origin can be a very effective way to shield existing producers from new competition (and to deprive consumers from potential benefits of regional tariff reductions).

This is sometimes rationalized as a defensive measure to protect producers in particular Member States from cost-raising effects of MFN import tariffs and other domestic policies that raise their own costs of raw materials and intermediate inputs. Forcing potential regional competitors to operate under the same policy-induced handicaps as those in a particular Member State has no economic rationale. At best it makes the PTA irrelevant for internationally competitive producers who source materials from the best international sources. At worst, it induces producers in other Member States to adopt high cost, internationally uncompetitive production methods, not for normal economic reasons, but simply to satisfy the rules of origin.

- Strict rules of origin can induce producers to use regional raw materials, thus giving protection and encouragement to the producers of such goods. Such an incentive is necessary only if their local/regional production costs are higher than international prices of the same goods. Therefore, the burden of rules of origin designed to encourage regional production of raw materials and intermediate inputs will be borne in the form of higher costs by downstream user industries, making them less competitive internationally. Such a strategy can 'work' only if members' external tariffs on finished products are high enough to make it worthwhile to use regional materials when they would not otherwise have been used. In the longer run, however, such a strategy is self-defeating since it reduces rather than increases the global competitiveness of regional producers.

There is no question that rules of origin can have substantial protective effects. To reduce tariffs on regional trade only to replace them with much less transparent and often more restrictive rules of origin is a questionable way to achieve the benefits of trade liberalization.

### **2.3 Other Uses of Rules of Origin**

Many other possible uses have been proposed for rules of origin in SADC. Among these have been enforcement of consumer and industrial safety standards, protection of the regional environment, and preventing foreign goods from being dumped in local or regional markets.

Liberalization of regional trade, it has been claimed, might impose new threats in these areas. There is very little evidence about the likelihood of these threats, and in most instances it appears that the risks are low. In each case there also exist a wide range of instruments that should be more suitable, more effective and have less costly side effects than rules of origin for dealing with the concerns at hand.

Fears have been expressed that the 'normal' instruments for dealing with these problems might not work. This is not an argument for using rules of origin; rather, it points out the need to improve the design or implementation of the normal tools. The use of restrictive rules of origin, with consequent harmful effects on achieving the goal of regional economic integration, would be a much less effective (often completely ineffective) and more costly alternative. Box 2 discusses the use of rules of origin to enforce safety standards for electric cable.

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<sup>1</sup> Producers are free, of course, to source raw materials wherever they wish, subject to import regulations and taxes in their own countries. But if they do not meet the requirements of the PTA's rules of origin, they will not qualify for preferential access to other markets in the PTA.

## 2. Safety and Dumping: The Case of Electric Cable

Electric cable is manufactured in a number of SADC Member States, including most importantly South Africa, Zambia and Zimbabwe.

Manufacture of electric cables includes the production of copper or aluminum wire to the correct standards, combining the appropriate numbers and types of threads for each conductive element, insulating and wrapping each conductor, and wrapping the entire cable. In the case of South Africa, the South African Bureau of Standards (SABS) defines safety standards for all cable products sold in the country. These standards are enforced through regulation of South African factories in the case of domestic production, and by licensing importers of foreign produced cable. All cable imports require a letter of authorization from SABS.

Fear has been expressed that imported cable from otherwise reputable producers in Zambia or Zimbabwe, say, might have its safety standards compromised if the producers did not control the entire manufacturing process. For instance, they might import substandard insulated conductor core from some unreliable external producer and simply wrap it into a finished cable. If they stamped the final product 'made in factory X in Zimbabwe (or Zambia)', a South African importer would have no way of knowing otherwise, and there is a considerable likelihood that the substandard cable would find its way onto the South African market as a SABS-approved product.

The proposal to solve this problem through very high local/regional content requirement for preferential SADC trade has a superficial attractiveness. However, on closer inspection, this is not a solution. A fraudulent claim about the origin of the materials used in manufacture of the cable would be just as difficult to detect as a fraudulent claim about their quality. Relying on rules of origin as an indirect solution to this potential problem would be less likely to succeed than a direct attack on the safety issue itself. If this is actually a problem, what are needed are improvements in risk management and inspection systems by importers and, if necessary by SABS, that would suffice to deal with the risks envisaged in regard to product quality.

The concern about dumping arises in part from frustrations about the failure of existing anti-dumping mechanisms to satisfy claims about dumping of cable from Korea and other sources into the South African market. This has led to a fear that SADC free trade might lead to 'indirect dumping' – the import of dumped cable components in a neighboring country that will then receive some finishing and be re-exported as finished cable to South Africa.

It is suggested that a very restrictive rule of origin prohibiting preferential imports of cable with significant import content would eliminate this potential problem. Once again, this is an indirect approach to a problem that lies with alleged weaknesses in anti-dumping laws and procedures in South Africa.

A blanket prohibition of certain types of trade on the grounds that it might be a vehicle for dumping is a very blunt and costly alternative to improvements in anti-dumping laws. Furthermore, despite their potentially very high costs, such measures would not solve the problem. A considerable amount of international trade in cable already takes place, even without SADC free trade. About 35 percent of South African cable demand is already satisfied by imports, despite a 15 percent import duty. An importer wanting to engage in 'indirect dumping' of the type envisaged here, could do so simply by forgoing SADC tariff preferences. Rules of origin for SADC free trade would be a costly, inappropriate and ineffective instrument for dealing with potential problems of 'indirect dumping.'

### 2.4 Weak Customs Administration

Regional Customs administrations are said by some to be incapable of enforcing rules of origin. As a result, it is feared that low cost goods from Asia will enter SADC through porous borders of certain Member States, be granted SADC tariff preferences, and destroy regional industries. More restrictive rules of origin are the suggested solution. This begs the question of why a weak administration should be more capable of enforcing restrictive rules than less restrictive ones.



In fact, the restrictive rules that are proposed in many cases could not be satisfied by any regional producers. Therefore any imports that claim SADC preferences would be known to be illegitimate. No administrative discretion would be necessary.

Solving problems of weak administration by making it impossible for any trade to qualify for SADC preferences subverts the trade liberalization process. Improving administrative systems and capabilities might be a more direct and less costly alternative.

### **3. Rule of Origin Issues in SADC**

Rules of origin have been among the more contentious issues in Trade Protocol negotiations. Indeed, even two years after implementation of the Protocol, rules have not yet been agreed in several key sectors. A useful way to appreciate themes and issues involved in the discussions is to examine particular sectors in which controversies have arisen. In a number of the cases discussed here rules of origin have yet to be agreed.

#### **3.1 Wheat, Wheat Flour and Their Products<sup>2</sup>**

Rules of origin have not yet been agreed for wheat flour or for products of wheat flour. The outstanding differences are basically between wheat-producing and non-wheat producing Member States. The main issue is whether use of locally or regionally grown wheat should be required for flour to qualify for SADC preferences.

There are several proposed rules of origin under consideration for wheat flour. The principal wheat producing Members have proposed a highly restrictive rule requiring that at least 70 percent by weight of the raw materials used wholly originate in the region. Others have proposed a less restrictive rule, requiring only that no more than 65 percent of the value of the materials used be imported from outside SADC – i.e. that only 35 percent of the value of the materials used be sourced from within SADC. Mozambique has proposed a variation of the second rule that would impose the same requirement, but limited by quota and subject to expiry if and when regional wheat producers can meet all regional demand. In addition, a report prepared by a consultant to the SADC Secretariat proposed a rule of origin requiring simple change of tariff heading – i.e. requiring only that the flour be milled in a Member State (Flatters 2002a).

Discussion of these alternatives has been diverted by questions about the need to protect local grain growers against unfair, subsidized international competition, about the implications of such protection for downstream millers, and by questions about wheat growing capacities in SADC, including whether SADC is or could be self-sufficient in wheat.

Insufficient attention has been paid to the actual operation of wheat and flour markets in the Member States. A closer examination of these markets leads to some simple conclusions about the implications of alternative rules of origin.

There has been considerable resistance to liberalization of SADC trade in wheat flour and its products. This is due primarily to the very high levels of protection currently enjoyed by local milling industries in almost all Member States. With the exception of Malawi, Mauritius and to a lesser extent Tanzania, current MFN tariffs provide high levels of effective protection – 75 to 127 percent – to domestic wheat millers. In all but one of these the rate of effective rate of protection is 99 percent or higher. This means that local millers can have processing costs that are at least double those in normal international flour mills and still compete against imports.

If these mills are able to reach normal efficiency levels, as many are able to do, these margins translate into enormous economic rents, or excess profits.

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<sup>2</sup> The discussion in this section draws on Flatters 2002a.

SADC millers also benefit from significant amounts of natural protection from international transport costs of wheat and flour.

In addition, a number of Member States provide additional protection through non-tariff import barriers (NTBs). The most important of these are import licensing schemes that require local purchases as a condition for importing flour.

The burden of all this protection of local milling industries falls primarily on domestic consumers of flour products, especially bread. For SADC producers of downstream products such as biscuits that are attempting to sell in world export markets, protection of flour is also a barrier to their international competitiveness.

The main impact of a restrictive rule of origin will be to ensure that no intra-SADC competition will emerge to erode the protection currently afforded SADC flour millers – that is, such rules will preserve the current levels of protection to SADC milling industries.

A principal rationale for continued protection of flour milling industries and hence for a restrictive rule of origin in SADC is to compensate millers for the alleged cost-raising effects of policies designed to protect domestic wheat growers. Protection of local wheat growers is justified, in turn, on the basis of distortions in international grain markets arising from protection and export subsidies by major international wheat producers.

In fact, protection of milling is far more than sufficient to compensate for any possible cost-raising effect of protecting grain growers.

Furthermore, there is considerable evidence that local wheat in South Africa is priced at less than import parity (before import duties). In other words, protection of wheat does not help local wheat growers and imposes no cost penalty on millers, at least in respect of domestic wheat, which accounts for the majority of their wheat purchases.

The rhetoric about the need to protect local wheat growers and the debates about whether SADC might ever be self-sufficient in wheat have diverted attention from the principal issue – an attempt to use restrictive rules of origin to preserve protected markets for wheat flour.

All Member States are net wheat importers and only a few produce significant amounts of wheat. The economic rationale for high levels of protection for millers in non-wheat-producing Member States is even less apparent.

If flour and its products are considered to be ‘strategic’ products or are felt to be essential for food security and/or poverty reduction, high levels of protection that serve only to increase local prices are not the solution. Flour is readily available at highly competitive prices in world markets. Furthermore, experience internationally and in SADC itself shows that local and international investors are able to develop local milling capacity and supply at competitive prices as long as they are not hindered by artificially high raw material prices and other regulatory restrictions. Special incentives and high levels of protection are not necessary. But competitive market conditions are essential.

Wheat milling is a substantive economic activity, regardless of the source of the wheat. It is not a ‘screwdriver’ operation. It requires large investments in milling and packaging equipment, testing facilities, and buildings. It employs substantial numbers of workers in logistics, production and packaging.

A simple rule of origin requiring a single change of tariff heading (from wheat to flour) is all that is necessary to authenticate that flour originates in the region, that it results from substantial economic activity in the region and that it should qualify for SADC trade preferences.

Some millers, especially in South Africa, are concerned about inequities arising from the slow pace of tariff reductions and the existence of NTBs on wheat flour imports in other Member States. They are correct.

There is no justification for a slower pace of liberalization of imports of flour in some States than in others. Flour milling does not suffer any particular disadvantages that justify a slower pace of liberalization in some countries than in others – whether on the basis of per capita income, country size or any other indicator of economic development.

A restrictive rule of origin is not the solution to problems of anti-competitive policies in some Member States. This would be an indirect and costly way of undoing the beneficial effects of tariff liberalization. The appropriate approach is for all Members to agree to open their markets at the same pace. Recalcitrant Members should speed up the pace of tariff reduction and eliminate NTBs on flour imports immediately.

If some Members insist on delaying the opening of their domestic markets, others might wish to reduce their own pace of tariff liberalization accordingly. This should be done directly and not through the ‘back door’ by introducing restrictive rules of origin.

Finally, if any Member State is unwilling to expose its millers to SADC competition, for whatever reason, the solution is for the Member to exclude this sector from its trade liberalization offer – not to insist on restrictive rule of origin that would disrupt trade among other Members that do wish to open their borders. Excluding flour would permit a Member State to continue to protect its flour millers from SADC competition, but it would also disqualify its millers from SADC tariff preferences in other markets.

Failure to agree on a rule of origin for wheat flour has made it impossible to reach agreement on products of wheat flour and other grains and starches (HS Chapter 19). This chapter includes a wide range of processed agricultural products. Some, such as tapioca, are similar to wheat flour, in that they are ‘one step removed’ from the original raw materials. Others, such as pasta and biscuits, are at least in part ‘two steps removed’ – products of agricultural products rather than of the raw materials themselves. In both cases some parties have proposed restrictive rules of origin based on requirements to use local raw materials whenever they might be available.

In the case of products that are ‘one step removed’ from the agricultural raw materials, the arguments are similar to those for wheat flour (and for tea, coffee and spices which will be discussed in a later section below). As in these other cases, the arguments are based on a fundamental misunderstanding of the interests of growers and of processors.

Processors prefer to use local raw materials when they are competitively supplied, in terms of price, quality and product description. When these competitive conditions are met, a restrictive rule is not required – producers will source locally out of their own self-interest. If the conditions are not met, restrictive sourcing requirements will reduce the competitiveness of regional processors. Not only will this raise consumer prices and harm the development of the processors, but it will also remove a source of demand for local raw materials – a lose-lose situation for all concerned. These arguments will be reviewed further below in connection with other processed and blended products.

In the case of processing that is further downstream – more than one step removed from the agricultural raw material – the case for simple and non-restrictive rules of origin is similar, but even stronger.

Good quality pasta requires durum wheat – a type that is simply not produced in the climatic and soil conditions prevalent in SADC. Local wheat can be used and some of the deficiencies can be overcome through use of special additives. While this makes it technically possible to produce ‘European’ type pasta, it is of higher cost and much lower quality. As one SADC supplier described

it, the resulting pasta is excessively brittle, with the result that a significant portion of the final product crumbles to powder before the consumer ever opens the package. This particular producer, who has ceased all local pasta production, claims that all local pasta producers use imported flour, despite high import duties.<sup>3</sup>

Requiring the use of local flour for pasta to qualify for SADC preferences will make the Trade Protocol irrelevant in yet another sector. This would suit a producer that currently serves a local SADC market behind very high protectionist barriers designed to protect a new 'infant' pasta factory. A restrictive rule of origin would simply preserve the protected markets and the resulting excess profits from the threat of competition from regional suppliers operating under the Trade Protocol. It would also eliminate the possibility of preferential trade among Member States that did wish to take advantage of the benefits of free trade in SADC. In recognition of this the Ministers recently agreed on a rule requiring only simple change of tariff heading for products using durum wheat.

If some Member States wish to exclude particular downstream flour products from SADC preferential trade, they should do so directly, by excluding these products from their liberalization offers. It should be understood that this would prevent their producers from taking advantage of SADC preferences under the Protocol. This is a reasonable price to pay for not participating in SADC trade arrangements in these sectors. But a restrictive rule of origin that would hinder all SADC trade is an inappropriate way to deal with the protectionist proclivities of particular members.

As in many other products, the gradual liberalization of trade policies and regulatory regimes, together with increased access to foreign markets has created new international export opportunities for SADC producers in these sectors. A South African biscuit producer has become a competitive exporter in Africa, the Middle East, Asia, Europe and North America. Exports account for a significant and growing share of production, employment and new investment. As with all other internationally competitive producers, an important key to success is skillful sourcing of raw materials.

Quality considerations require that these biscuits use wheat made from flour that is grown only outside of southern Africa. As with pasta, the only way that local flours could be used would be through the use of additives, which would make the products almost impossible to market in developed country markets.

To make SADC relevant for internationally competitive producers will require simple and non-restrictive rules of origin. Restrictive rules of origin will reduce their competitiveness and be of no benefit to upstream suppliers. The only possible 'benefit' might be to eliminate some regional competition for producers supplying some small domestic markets in SADC. This would be harmful to regional consumers and save or create a very small number of regional jobs at best. It would do nothing to promote the much larger investments and numbers of jobs that will arise from the development of internationally competitive producers in the SADC region.

A rule of origin requiring a simple change of tariff heading is all that is necessary and all that can be justified for these products. Reduction of tariffs and other import barriers should proceed at the same pace in all Member States. There is no economic rationale for infant industry protection of these products through any means. Restrictive rules of origin certainly should not be used for this purpose or as a means of delaying SADC trade liberalization on account of such practices in some Member States.

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<sup>3</sup> In the case of South African pasta exports, the effect of high import duties on flour is largely offset by use of the government's duty rebate facility for exporters.

### 3.2 Coffee, Tea and Spices

The side taken by any particular Member State on rules of origin for processed food products such as these has tended to depend on whether it is a significant producer of the raw material in question. Members that are producers of the raw materials and impose significant external tariffs on these products generally seek restrictive rules of origin (high regional content requirements), and those that are not major producers of the raw materials are happier with less restrictive requirements. The raw material producers have tended to have a louder voice and greater influence in the discussions.

The motivation for restrictive rules of origin in these sectors is to encourage regional economic activity, or to provide direct or indirect protection to regional producers of raw materials or processed products. A restrictive rule of origin is expected to

- increase demand for a regional agricultural product and hence the incomes of its producers and/or
- encourage downstream processing.

An early agreement on the HS chapter rule for these products required that locally produced materials account for at least 80 percent by weight of the final product in order for that product to qualify for SADC tariff preferences. There was one exception to this chapter rule. In the case of mixtures of spices (ex HS 09.10) the agreed requirement was that at least 80 percent of the *value* of the final product (ex works price) be attributable to regional inputs (or no more than 20 percent of the value of the product is due to non-regional inputs). One Member State subsequently requested that the rule for mixtures of spices be relaxed to require a minimum of only 35 percent (rather than 80 percent) local content. At the most recent Trade Negotiation Forum, the following rules were agreed:

- for tea, coffee and spices at least 60 percent by weight of the raw materials must be wholly originating in the region, and
- for curry and mixtures of spices, there must be a change of tariff heading and all cloves used in such mixtures must be wholly originating in the region.

A closer examination of the markets for the products concerned suggests that the negotiators' insistence on highly restrictive rules of origin reflects a fundamental misunderstanding of their likely effects. In fact, many of the relevant spices are not even available in the region, at any cost. They are unlikely to accomplish any of their intended goals and will have the unintended consequence of preventing almost all potential intra-SADC preferential trade. Furthermore, they will impede rather than encourage the development of downstream processing activities.

Two of the keys to successful downstream coffee, tea and spice blending are a) sourcing a variety of appropriate raw materials – in terms of quality, price and other characteristics – for blending purposes and b) efficient processing, creative packaging and marketing of the final products. See Box 3 for the case of instant coffee.

#### **3. International Sourcing for Manufacture of Instant Coffee**

As is well known to any aficionado, 'coffee' is not a homogeneous product. With few exceptions, most coffees available in the market are blends of beans from different sources, each with its distinct taste characteristics.

Instant coffee is no different. Producers source beans from around the globe in light of differences in price, quality and flavor. For example one major manufacturer in SADC sources beans from at least seven different countries in order to achieve a product at the right cost and with the appropriate flavor. The basic mix is roughly 60% robusta and 40% Arabica. Suitable robusta is not available anywhere in the SADC region, and so it is sourced in other parts of Africa (mainly Ivory Coast) and Asia (primarily Indonesia and Vietnam at the

moment). Arabica is sourced in a number of countries, including South Africa, Tanzania, Uganda and Zimbabwe. Overall, however, only five to ten percent of their coffee inputs are sourced in SADC.

The low degree of local sourcing is of no consequence to regional growers. Arabica coffee grown in the region is sold internationally – indeed some high quality Arabica products command very high premiums in Europe and other international markets. Increased local sourcing by regional processors would not affect the world prices of these products.

Instant coffee production is a substantial manufacturing process, with value added in the range of 40 to 50 percent of the ex works price. A 70 or 80 percent regional content requirement would prevent regionally manufactured coffee from benefiting from SADC trade preferences, an odd result given the goals of the Trade Protocol. Manufacture of the instant coffee in the region, regardless of the source of the raw materials, should suffice to qualify for SADC trade preferences.

High quality coffee, tea and spices are grown in a number of SADC Member States. A wide variety of lower quality products are also grown. Many of these products are exported internationally. Those of higher quality command correspondingly high prices in world markets. The participation of growers of these products in international markets means that restrictive rules of origin in SADC will have no effect on them. Any sales that might be diverted to regional markets as a result of restrictive rule of origin will simply replace one customer by another, with no impact on the sellers or the producers of the raw materials. A restrictive rule of origin for coffee, tea or spices will be of no benefit to local growers.

Consider the case of Tanzania, a competitive world producer and net exporter of coffee and cloves. Any diversion of its coffee or cloves to local or regional use would simply detract from international exports, with no net gain. The world price would obtain in either case. Furthermore, as we shall now see, restrictions of this sort are far more likely to discourage than to encourage any downstream processing activities. See Box 4 on South African fruit juice exports to COMESA as an illustration of the benefits of liberal rules of origin.

#### **4. South African Investment and Export Opportunities in COMESA**

South Africa has a well-developed and internationally competitive fruit juice industry. South Africa's non-membership in COMESA might appear to deprive her producers from preferential access to this neighboring market.

A combination of liberal COMESA rules of origin and entrepreneurial skills on the part of several actors might overcome this difficulty. According to the developer of a free zone in Mauritius, a major South African juice producer has been persuaded to explore the possibility of investing in Mauritius. The free zone operation would involve the processing and packaging of South African concentrate in Mauritius (a member of COMESA) for export to COMESA. The locally generated activity in Mauritius would suffice to meet COMESA's 35 percent rule of origin requirement.

The result would be the gain of a market opportunity for a South African producer, preferential availability of fine South African juice products in COMESA, and the generation of investment, employment and incomes in Mauritius.

If COMESA had in place a 45 or 60 percent rule of origin requirement such as those in effect or proposed for many sectors in SADC, this win-win-win opportunity would not have been possible.

Will a restrictive rule of origin encourage downstream processing? No, a restrictive rule of origin for the products in this chapter will not assist in the development of downstream processing industries. In fact, it would most likely have the opposite effect; that is it would decrease the overall competitiveness of coffee, tea, coffee and spice processors. See Box 3 on sourcing for the manufacture of instant coffee.

Processed coffee, tea and spices are very heterogeneous and differentiated products. The raw materials used are similarly heterogeneous and their characteristics are generally very location-specific – a product of climate, soil conditions and many other factors.<sup>4</sup> Relative to the variety of raw materials available in the world, SADC Member States produce only a very narrow range and a similarly limited set of varieties of the few products that are grown in the region.

Sourcing of raw materials for blending of coffee, tea and spices is a complex process. Producers everywhere, including SADC, source raw materials from all around the world. Buyers and suppliers must be alert to subtle quality differences across space and time; they must also pay close attention to price variations and to supply constraints that arise due changing supply and demand conditions in many different parts of the globe.

All other things equal, producers would prefer to source locally – for reasons of transport costs, speedy and reliable communication with suppliers, etc. Local producers work closely with regional suppliers and growers to develop local sources of raw materials where this can be done competitively.

For some products such as rooibos tea, the raw materials can be obtained only in the SADC region. For others, such as Ceylon tea, green tea and many of the spice raw materials that are essential in curries and other mixed spices, there are no local sources of supply in SADC. Branding, licensing, local health regulations and many other factors often determine where inputs must be sourced, and rules of origin cannot be used to overcome these requirements. Where flexibility is possible, however, skillful sourcing and selection of raw materials in the global market is a key to the international competitiveness of these producers. Therefore, restrictive rules of origin simply hinder the development of downstream processing industries. See Box 5.

#### **5. Gherkins: The Need for Flexible Sourcing of Raw Materials**

An example from a different HS chapter illustrates the importance of flexibility in sourcing raw materials and the absurdity of rules such as those in chapter 09. A company investigated in the course of this work produces a wide variety of food products, including pickled gherkins.

Gherkins are grown competitively in SADC and the company routinely buys locally. However, a recent crop failure created an emergency and required the company to source gherkins from Turkey, at considerable extra cost. Under the proposed chapter rule for HS chapter 09, the use of imported gherkins would disqualify these pickles from SADC trade preferences. This would provide no benefit to local gherkin growers and would be harmful to regional producers and consumers.

In any other year, the rule would be easily satisfied. But it would be redundant; producers would source locally regardless of the rules of origin. In normal years, the restrictive rule would be unnecessary, and in unusual years, such as that described here, it could not be fulfilled and would only cause harm to local producers and consumers.

There are a number of successful and internationally competitive SADC producers of the products included in HS chapter 09. Regional producers of coffee, tea and mixed spices already export within the immediate region, to the rest of Africa and to many other parts of the globe, including Asia, Europe and North America. Arbitrary and restrictive rules that limit flexibility in raw material sourcing will reduce their competitiveness and harm regional consumers.

Restrictive rules of origin would exclude from SADC preferences most of the products currently produced in the region, including many in which non-preferential trade is already taking place. Even

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<sup>4</sup> The time, effort and resources devoted to exploration and colonial wars over several centuries in China and the East Indies is testimony the location-specific nature of growing conditions for a wide variety of spices, teas and coffees.

Member States that might have some comparative advantage in tea, coffee or spice blending by virtue of local availability of some of the necessary ingredients would be deprived of preferential access to SADC markets under current rules. Flexibility in international sourcing of raw materials is essential to international competitiveness. As currently framed, the Trade Protocol will restrict it, at least with respect to preferential trade within SADC. As with wheat and wheat flour, the ultimate cost of restrictive rules of origin on these products will be borne by regional consumers.

### 3.3 Machinery and Electrical Products

A number of unresolved rules of origin issues remain in the manufacturing sector. Many of the principal ones are in HS chapters 84 and 85. These chapters comprise the heart of what might be termed light manufacturing industry (machinery, electrical and electronic goods and components).

The rules of origin agreed at a chapter level in many manufacturing sectors are quite restrictive – requiring high levels of local/regional content in order for goods to qualify for preferential treatment in intra-SADC trade. Such rules are certainly much more demanding than would be required for simple authentication of origin, or for prevention of tariff jumping.

A number of different justifications have been provided for such strict rules. Many are based simply on the desire to protect existing industries against the possibility of increased competition arising from the freer trade in the region. The arguments for protection through restrictive rules of origin range from vague fears of greatly increased and somehow unfair competition, to more subtle defensive arguments based on the high cost of achieving existing levels of local content in the face of protective import regimes.

There are other instances in which Member States have demanded restrictive rules of origin as a form of insurance, ‘just in case’ some local manufacturing activity that might be threatened under tariff-free preferential access by other Member States. This ‘insurance’ is often unnecessary and misguided, not only because it violates the intention of using the Trade Protocol to promote freer trade in SADC, but also because the Members in question have no significant local industry to protect anyway.<sup>5</sup>

A variation on the same argument is the fear that trade liberalization will lead to a flood of imports from new ‘screwdriver’ industries set up in neighboring countries to take advantage of the Trade Protocol. These concerns are well taken care of by specific prohibitions set out in the Protocol. See Box 1 above on the dangers of competition from ‘screwdriver’ industries, and on provisions in the Trade Protocol to prevent this.

A variety of other arguments based on safety, environmental protection and the possibility of dumping have been presented in particular cases as well.

The types of industries and firms represented in these sectors cover a very wide range.

Domestic incentive structures – relatively high tariffs on final goods, lower tariffs on imported components or kits, and sometimes additional incentives to source some inputs locally – have encouraged the development of a number of high cost activities that are unable to compete internationally in terms of price or product quality. The small scale of production necessary to meet local market demand makes it difficult to achieve internationally competitive cost levels. These activities nevertheless remain a source of a certain amount of income and employment, supported at the expense of consumers and/or industrial users of the protected goods.

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<sup>5</sup> In one instance in which a Member State pressed for restrictive rules of origin it turned out that the industry in question comprised only two firms. One was an internationally competitive exporter and had no need for or interest in a restrictive rule of origin. The other firm, a high cost import substitution producer, had already gone out of business – apparently unbeknownst to the country’s negotiators.



There are also a significant and growing number of internationally competitive export activities in these sectors. There are examples of intra-industry trade within the region as well as exports in a variety of niche markets to various other parts of the world, including Europe and North America. Extra-regional exports account for a growing share of production in these sectors, and also generate considerable employment. Many of these are 'new exports' that have become more competitive due to MFN-based trade liberalization in the region over the past decade. What were once inward-looking import substitution industries have become much more active players in global markets. This has generated many new jobs for workers in the region – far more in general than can be created in uncompetitive import substitution activities.

In the early stages of Trade Protocol negotiations, there was a proposal for a general rule for products in Chapters 84 and 85. For goods to qualify under this chapter rule, non-originating raw materials could not exceed 65 percent of their ex-factory cost. In other words, a minimum local/regional content of 35 percent of ex-factory cost was required.

It was then proposed that the basis for value calculations be changed from ex-factory cost to ex-works price. According to calculations presented by SACU, this would have the effect, on average, of raising the domestic content threshold from 35 to 45 percent, or lowering permitted non-originating content from 65 to 55 percent. On the other hand, a proposal by a special sub-committee to permit non-originating materials accounting for up to 65 percent of ex-works price remained on the table as well.

At the most recent trade negotiating meetings in Windhoek (August 2002) a compromise was reached on the chapter rule for chapters 84 and 85, requiring a maximum import content of 60 percent of the ex-works price. In addition, there are nine four-digit HS chapter sub-headings where a more restrictive 45 percent maximum import content has been agreed, and there remain eleven sub-headings in which no rule has been agreed.

The actual degree of local content achieved in existing regional industries in these chapters varies considerably. Some industries have levels of local content that are less than those specified by the chapter rule, and many achieve considerably higher levels. In general, it is unlikely that the chapter rule will be a serious impediment to competitive trade for most existing industries. However, for some highly competitive global export industries in these sectors, a less restrictive rule of origin would undoubtedly enhance trading opportunities in the region. See Box 6 on sourcing by internationally competitive exporters.

#### **6. Rules of Origin and Internationally Competitive Exporters**

As a result of progressive trade liberalization and deregulation of the domestic economy, South African producers have had great and often unrecognized success in integrating with the global economy. The result has been increasing international competitiveness and growing exports in a wide range of products. This, in turn, has generated considerable employment for South African workers.

Valves and small electric appliances are but two examples. Although their experience with respect to international sourcing of raw materials has been quite different, both examples provide important lessons for the design of rules of origin for the Trade Protocol.

The term 'valves' covers a wide variety of industrial and consumer products. The two large local markets are for water systems and for the mining industry. South Africa imports valves of some types and exports others. Because of the relatively small size of the domestic market, it tends to import standardized products that benefit from large economies of scale in production. On the other hand, South African producers are competitive in a number of products with shorter production runs.

As a result of their long experience supplying the South African mining sector, local producers have built up expertise in production of valves used in the mining industry, especially for the transport of slurry. This has

generated a steady demand for these products from the mining industry around the world. Exports account for over one-third of total production.

By the nature of the materials and production processes, valves rely heavily on domestic materials. The bulk and weight of iron castings make them costly to import. Therefore, a relatively restrictive rule of origin would not be a major hindrance. On the other hand, the natural protection provided by production and transport costs also means that producers have nothing to fear from a very liberal rule of origin. Competitors planning to rely on imported components would face much higher costs than local producers. Furthermore, a more liberal rule would provide flexibility for these internationally competitive local producers to take advantage of any cost-saving import possibilities that might arise.

The South African electrical appliance industry has evolved in response to the opening up of the domestic economy. Production has been rationalized considerably. There is still some production aimed specifically at the protected domestic market. Some is of a relatively simple assembly nature and accounts for correspondingly low levels of employment. At the other extreme are examples of internationally competitive export production, which account for much higher levels of employment than domestically oriented sales. One domestic company now accounts for about 4 percent of the entire global market for electric kettles.

Export production is very competitive. Exporters of electric appliances prefer locally sourced components when they can be supplied competitively. But local sourcing varies considerably across products. To remain competitive they must have the flexibility to source anywhere in the world. Internationally branded vacuum cleaners exported to the Middle East use motors from Italy. Simple cord sets for kettles and other exports are sometimes sourced domestically and sometimes from as far away as China. *It is the flexibility to source from anywhere that permits them to remain competitive.*

A SADC rule of origin requiring 60 percent local content could be met for some products. A 45 or 50 percent rule would broaden the range of possibilities. But a 35 percent rule would be much preferred. This would provide the kind of flexibility currently used to compete in the much larger and much more interesting global market.

Restrictive rules of origin are a hindrance, not a benefit, to internationally competitive exporters.

It seems evident as well that a 35 or 45 percent local content threshold, together with the general disqualification of pure assembly industries will more than suffice to prevent unfair competition from 'screwdriver' assembly activities. See Box 1 above on rules pertaining to 'screwdriver industries'.

In almost all cases in which a more restrictive rule has been agreed or proposed, the amendments are in respect of goods that already are produced in the region, most usually in South Africa and/or Zimbabwe. In most cases it is SACU that has proposed the alternative, more restrictive rule.

A principal justification for the more restrictive rules can be paraphrased as follows.

"Our domestic industry already achieves a high level of domestic content; achieving high levels of local content is costly, and allowing competitors to 'get away with' lower levels of local content would give them an unfair advantage under SADC free trade."

This is similar to one of the arguments for strict rules of origin for certain raw material processing activities, especially wheat flour – a strict rule of origin is a form of protection to compensate local producers for the cost-raising impacts of other government policies, in this case policies that encourage costly increases in local content of certain manufacturing activities.

Producers would not voluntarily engage in cost-raising methods of production unless government policies required it and/or unless they were given some financial incentives for doing so. Assembly of products from CKD kits for sale in a protected domestic market is an example of a cost-raising activity encouraged by high tariffs on final products and lower tariffs on kits and components. See Box 7 on refrigerator production in Mauritius.

### 7. Refrigerators: Rules of Origin and Regional Trade Liberalization

Mauritius belongs to COMESA as well as SADC. Prior to its membership in either of these groupings, it had developed a number of simply assembly industries for certain consumer durables. A refrigerator assembly industry had developed under the protection of an 80 percent import duty on assembled refrigerators and a 20 percent duty on completely knocked down kits. This provided effective protection of over 150 percent to the local assembly industry and was sufficient to keep out most imports. It also raised the cost of refrigerators to Mauritian consumers by close to 80 percent. And these consumers had to make do with technology that was many years old, hence forgoing many new conveniences and energy saving technologies enjoyed by consumers elsewhere in the world.

Following the introduction of free trade under COMESA, the refrigerator industry came under pressure from competing Egyptian products. What was the response of the Government of Mauritius?

The Government of Mauritius felt it was inappropriate for Egyptian producers to have special access to the local market simply by virtue of Egypt's membership in COMESA. The response, however, was *not* to erect new barriers to these imports as they may have been urged by local producers. Instead, they decided that local consumers should be able to benefit from competition by *all* local and international producers of refrigerators.

To accomplish this, the MFN import duty on built up refrigerators was reduced to 20 percent, the same as the rate on CKDs and parts. This gave local assemblers a reasonable rate of effective protection of 20 percent and allowed consumers the benefit of equal access to all international suppliers of refrigerators. The 20 percent import duty together with the relatively new VAT provided substantial increases in government revenues.

The only possible losers were those engaged in local refrigerator assembly. The main assembly operation did indeed shut down; its scale was far too small to be competitive. The company now concentrates on imports, distribution and sales of these products in Mauritius, in line with its main economic activity, with an insignificant change in its net income.

What about employment? The 15 to 20 persons who had been engaged in refrigerator assembly had to be redeployed elsewhere in the company – a minor adjustment for all concerned.

The COMESA rule of origin for refrigerators requires 25 percent local/regional content. (The general rule for the manufacturing sector is 35 percent.) A 60 percent local content rule such as that proposed by SACU for application in SADC would have eliminated the import 'threat' (or opportunity) that triggered these changes in Mauritius.

The goal of the Trade Protocol is surely not to replace tariffs on final products with rules of origin that rationalize the continuation of policy-induced high cost local content. Far more appropriate is a change in government policies so as to encourage efficient and competitive manufacturing activities. This requires flexibility in the sourcing of raw materials and intermediate inputs.

Of course, not all increases in local content raise costs. To be able to compete, whether in the local or international market, producers actually would prefer to be able to source raw materials and inputs locally. But to remain competitive, they also must have the flexibility to obtain such materials from the best possible sources, as measured by the net effects of price, quality and other conditions of delivery.

When high levels of local content are motivated by cost savings and by efficient production rather than by responses to government edicts or incentives, existing producers have nothing to fear from competitors that might set up operations with lower levels of local content in the same country or in other SADC Member States. Even if changing technology or new marketing possibilities made lower local content production methods more competitive, existing producers would be better placed to adjust than new competitors. See Box 6 above on competitive export production in the valve and electric appliance industries.

The more restrictive rules of origin proposed by SACU and others for a large set of products in Chapters 84 and 85 are similar to those required to qualify for preferential trade with the European Union (EU). The use of the same rule for EU trade might be thought to recommend it as an appropriate rule of origin for intra-SADC trade. Even if these rules of origin were appropriate for Africa-EU trade, they certainly would be far too restrictive to make sense in SADC. See Box 8 on EU rules of origin.

#### **8. EU Rules of Origin: An Appropriate Model for SADC?**

In a number of manufacturing sectors in which 'special' rules (i.e. more restrictive than for the chapter as a whole) are proposed, the proposals are strikingly similar to those contained in trade agreements between Africa and the EU – most notably the ACP-EU and South Africa – EU agreements. Are such rules appropriate for SADC?

A major difference between free trade deals with the EU and free trade within SADC is that rules of origin for trade with the EU count EU-sourced raw materials and components as 'originating' materials, thus contributing to meeting the local/regional content requirement. Thus movements and crystals purchased from Europe count as originating value-added in African produced watches exported to the EU. Textiles sourced in Italy are included in 'local' value added in African produced garments exported to Europe. European-sourced lenses, plastics and metal frame material count towards 'local' value added in sunglasses made in Africa for export to the EU.

To apply, say, a 60 percent local content rule in determining origin for intra-SADC trade would be a much harder test to meet for these and many other products. This is because components and materials that are routinely sourced in Europe for goods exported to the EU would not be available within SADC and hence would not be able to be used to meet local/regional content requirements.

The entire SADC market, including South Africa, is smaller than Turkey, and its industrial structure is relatively undiversified and technologically unsophisticated. The use of developed country rules of origin for SADC is inappropriate and costly. Using EU-based rules of origin as a standard for the SADC Trade Protocol would have the intriguing effect of disqualifying from SADC free trade preferences a wide range of goods that African producers export competitively to the EU!

Whatever might be appropriate for determining eligibility for preferences on Africa-EU trade, much less restrictive rules are needed to make any sense of and to gain any benefit from free trade within SADC.

The agreed rules now include as well a requirement for the local assembly ('population') of printed circuit boards (PCBs) in television receivers and video monitors. There is no justification for such a requirement in terms of the need to avoid tariff jumping or trade deflection.

If local population of PCBs makes economic sense (i.e. is less costly than importing already assembled boards), then self-interested actions of profit seeking producers will ensure that this happens. But if it is less costly to import than to assemble PCBs, there is no economic argument for the use of SADC rules of origin to encourage such activity by making it a requirement to qualify for SADC trade preferences.

In summary, the prohibition of 'screwdriver' assembly operations together with the general chapter rule requiring 40 percent local content relative to ex-factory price is more than sufficient for authentication of origin of manufactured goods in these chapters. Additions to these requirements are at best unnecessary, and at worst will serve as a barrier to intra-SADC competition and make the SADC market irrelevant for many producers, especially those that are fully engaged and competitive in the international economy.

To impose stricter rules of origin would encourage certain small and inefficient import substitution industries and perpetuate high cost and non-competitive industrial structures. As such, this would

hinder SADC's role in promoting free trade in the region and in becoming a platform to increase the region's competitiveness in world markets.

Two other reasons have been put forward as possible justifications for the more restrictive rules of origin proposed for Chapters 84 and 85. The first is as a means of ensuring the enforcement of consumer and industrial safety standards, and the second relates to the protection of domestic industries against dumping by foreigners.

Without questioning in any way the importance of achieving these social and economic goals, it is clear that rules of origin are not an appropriate instrument. In fact, the use of SADC rules of origin for these purposes would be very costly and almost certainly ineffective. See Box 2 above for a discussion of these dumping and safety issues with respect to the case of electric cable.

### 3.4 Textiles and Garments<sup>6</sup>

Textiles and garments are of particular interest in SADC for several reasons. This is one of the few manufacturing sectors in which there is significant production in a number of Member States. Differences in labor intensity at various stages in the textile and garment 'value chain' also mean that there are potentially significant complementarities among Member States which, through SADC trade initiatives, might enhance the region's competitiveness in world markets. It is a sector in which some Member States, most importantly Mauritius, have already demonstrated the potential of the region to promote growth and poverty reduction through international exports. And finally, the opportunities recently opened up through the Africa Growth and Opportunities Act (AGOA) make this a crucial time for remedying domestic and regional policy weaknesses that heretofore have hindered the region's international competitiveness.

As currently agreed, the movement to SADC free trade in textiles and garments is slow, and the sector is subject to relatively complex transitional arrangements. Most non-SACU Member States have postponed significant tariff reductions until very late in the transition process. Even SACU has postponed full tariff liberalization in this sector until 2005 (and even later in the case of clothing).<sup>7</sup> With a few exceptions and except for yarn, the rules of origin require double transformation in order to qualify for SADC tariff preferences – garments must be made from regionally produced textiles; fabric must be made from regionally produced yarns; yarn must be made from uncarded, uncombed fibre or from chemical products. The double transformation rules for garments and fabric are waived for the MMTZ countries, but only until 2005, and subject to very small quotas.

Many Member States apply relatively high MFN tariffs to goods in these sectors, and so free trade access to SADC markets would provide a high degree of preference relative to external markets. The rules of origin are less restrictive than those under AGOA, but nevertheless will be very difficult to satisfy for most regional garment producers.

The rules of origin and tariff liberalization schedules in SADC were shaped primarily by the existing policy regimes and by the constellation of interests in the domestic textile and garment industries in the Member States. It is important to note that the general shape of the negotiated rules was determined before the passage of AGOA.

With a few exceptions the SADC region's textile and garment industries have tended to be inward oriented and uncompetitive in international markets. MFN tariff rates are high, and most sales of domestic industries are in domestic and regional markets. Even within the most heavily protected markets, however, the ongoing process of trade liberalization, the opening of external opportunities,

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<sup>6</sup> This section draws on Flatters 2002b.

<sup>7</sup> South Africa has recently proposed an acceleration of the tariff phase down in these sectors, conditional on similar actions by other Member States. However, it must be noted that the sector will remain constrained by SADC's very restrictive two stage transformation rule of origin requirement.

and in some cases the provision of special export incentives have generated internationally competitive activities at all stages in the textile and garment value chain.

Each SADC Member State is unique, and so generalizations are difficult to make. Nevertheless, much can be learned by focusing on the dominant players in this sector – South Africa and Mauritius. While these are the dominant players, their different circumstances – the former largely inward looking and the latter much more export oriented – have resulted in quite different interests in and approaches to SADC. Some observations are offered as well on Namibia – until very recently one of the very smallest players in the regional textile industry.

### **South Africa**

South Africa's textile and garment sector is heavily protected and/or regulated at all stages in the value chain. The tariff structure is high and escalating, with tariff rates of 10 to 18 percent for yarn, 20 to 22 percent for fabric, 34 percent for blankets, linens and curtains, and 40 percent for garments. Cotton fibre imports are duty free but are subject to domestic purchase requirements – all domestic fibre must be purchased before imports are permitted.

This structure of protection has created a domestic industry that is focused primarily on the domestic market. While the import duty on garments is 'only' 40 percent, the escalation of the tariff rate structure provides effective protection to garment making in the neighbourhood of 60 to 70 percent for domestic sales. This is despite the cost-raising impact of relatively high import duties on fabric.

At the same time, export incentive programs, especially the duty credit certificates (DCC) program, have created a number of niche market exporters, in capital-intensive upstream sectors as well as labor-intensive garments. At whatever stage they are located in the textile and garment value chain, most exporters rely primarily on imported raw material inputs.<sup>8</sup>

In the upstream fibre, spinning and weaving industries only a small proportion of sales appear to be in the form of 'indirect exports' through garment producers. Most spinning and weaving firms produce a variety of products, only a small share of which are used in the garment industry. Products include shoe cloth, bedding and furniture upholstery fabric, and industrial cloth for many uses including tire cord, car seats, car tops, seat belts, luggage, road fabric and mining curtains.

Experience so far is insufficient to demonstrate the capacity to meet the demanding requirements of US and European garment makers; this is not unusual in the face of international experience. Neither simple estimates of aggregate yarn and textile manufacturing capacity nor broad statements of capability and willingness of textile makers to meet garment buyers' demands can be taken as evidence of true capacities to meet the demands that will be forthcoming under AGOA.

For firms that do export, the most important exports are industrial textile products that are assisted considerably by the DCC program. Even garment exporters are similar to those in Mauritius – i.e. they source inputs internationally. The result is a dual market – activities focused on exports and those aimed at the high cost and heavily protected domestic market. The latter is still the dominant part of the RSA industry.

### **Mauritius**

The textile and garment industry in Mauritius is predominantly export-oriented. A large part of her economic success over the past three decades can be attributed to the policy

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<sup>8</sup> Stern and Netshitomboni 2001 document the small share of current South African garment exports that currently qualify under the AGOA rules of origin.

environment which facilitated easy and low cost access to world markets for inputs and outputs. This permitted Mauritian-based textile and garment producers (and those in many other sectors as well) to become internationally competitive. Access to duty free imports and other export processing zone (EPZ) privileges made a significant contribution to the growth of the Mauritian textile sector.

At the same time, an interesting feature of trade policy over the same period has been the continuation of relatively high rates of protection to a wide range of import substitution industries. Until very recently, the tariff structure has been characterized by high and variable rates, with an escalating pattern that encouraged inefficient local assembly industries. A long-entrenched myth about the importance and fragility of such import substitution industries perpetuated a high cost policy regime for an unusually long time.

It is only relatively recently, with the recognition of the small amounts of employment in these industries and the high costs they impose on consumers, together with the introduction of a VAT which reduces reliance on import duties for government revenue that Mauritius has begun to rationalize its import duty regime (Box 7 above).

It is a testimony to the effectiveness of the EPZ system and to the market-friendliness of the rest of the investment and industrial policy regime that the export-oriented economy in textiles and other sectors was able to develop so successfully in spite of these persistent import substitution measures.

It is also testimony to the strength of the import substitution mentality that certain groups, even in the internationally competitive textile and garment and textile sector, initially supported restrictive rules of origin and a slow phase-in of SADC free trade in this sector. However, it is now almost universally recognized in Mauritius that a speedy phase-in of tariff reductions and minimally restrictive rules of origin are in the best interest of future development in Mauritius. Most representatives of the textile and garment sector would now advocate immediate SADC-wide free trade and a single transformation rule of origin as the best way for Mauritius and the rest of SADC to take advantage of the unique and time-limited opportunities provided by AGOA.

### **Namibia**

Namibia is a very small country, at least in terms of market size for garments and textile products. Under SACU, of course, it is part of the greater South African market and benefits (and suffers) from many of the features of the South African trade and industrial policy regime. Historically, it has not been a participant in the regional or global garment and textile industries. As recently as mid-2001, studies of regional development possibilities in this sector did not give any serious attention to future possibilities in Namibia.

While there continues to be talk about the need to develop import substitution industries in Namibia, garments and textiles have not been part of any such schemes. Furthermore, there is growing recognition that any significant investment and employment possibilities in the manufacturing sector must ultimately be export-oriented. It is in this context that Namibia was well prepared to take advantage of the opportunity to host the huge AGOA-oriented investment being planned by the Malaysian company, Ramatex Bhd. (see Box 12 below). With no vested interests in preserving access to a protected domestic market, the government encountered no extraneous constraints in negotiating arrangements with this large investor.

The current rules of origin, requiring double transformation in order to qualify for SADC tariff preferences, were formulated prior to the passage of AGOA and so were focused primarily on opportunities for trade among SADC Member States, and not with the rest of the world.

South Africa's rationale for the double transformation rule is that it will encourage regional sourcing and deeper integration of the regional textile and garment industries. A closer examination of the South African industry itself, however, shows that there is little such integration, even within South Africa. South African garment exporters, and even the majority of producers that sell primarily in the domestic market, use imported fabric (see Box 9). The same is true, and in fact even more so, of SADC garment makers outside of South Africa. This is not surprising in light of the much lower stage of development of upstream textile industries in most in SADC outside of South Africa.

### **9. Sourcing by Garment Producers: Current Practices and SADC Rules of Origin**

Under the current rule of origin regionally produced garments must be made from regionally produced fabric to qualify for SADC preferences. The stated rationale for this rule is to use the Trade Protocol to encourage the development of regional input supplying industries. This view was put forward especially forcefully by South Africa, which has the region's best developed spinning, weaving and knitting industries.

What is the current practice of South African garment producers, when producing for the domestic and international markets?

When producing for export, South African garment producers can qualify for duty exemptions or duty rebates on imported fabrics and yarns, and/or for duty credit certificates in respect of their exports which can then be used to secure imported inputs. It is not surprising, therefore, that South African garment exporters use almost entirely imported fabrics in their export production.

Even when producing for the domestic market, South African garment makers rely heavily on imported fabric. Domestic demand is influenced by international fashion trends in both design and materials. Retailers must respond accordingly. A supplier of garments to one of South Africa's major retail chains buys 90 percent of its fabric internationally. It would prefer to source a higher proportion locally and in fact has made a number of attempts to increase the degree of local sourcing. On several recent occasions it was seriously let down by quality problems and delivery delays when trying to expand its local supply network.

When asked how the company would respond to a requirement that its garments be made from domestically or regionally produced fabric, the owner replied: "We could not compete; we would shut our doors tomorrow." This is despite import duties of 40 percent on its products.

Another manufacturer of brand name apparel uses Italian cotton fabric for its high end products. Such fabric cannot be obtained from a South African producer at any cost.

If these are the current practices of South African garment producers, how much regional production is likely to qualify for SADC preferences under the current double transformation rule? Very little. It is apparent that almost no regional production would qualify for SADC regional preferences under the current rule. Maybe that is the point.

If not even South African garment producers can satisfy the double transformation rule, why did South Africa insist on enshrining it in the Trade Protocol? There are two plausible answers. One is ignorance. In early stages of the Trade Protocol negotiations South African officials sought the advice of the textile industry on rules of origin in this sector. As a quick response, industry representatives proposed existing EU rules. Despite their obvious inappropriateness for SADC, enshrining these rules in South African agreements with the EU gave them an air of respectability that was unquestioned in both the industry and the South African government (Box 8 above).

The second possible reason for South Africa to propose rules that could not be met by their own industry lies in the structure of their MFN tariff protection of textiles and garments (see Box 10). South African garment makers that sell in the domestic market and hence do not benefit from duty rebates or duty credit certificates (DCCs) suffer from the cost-raising impact of high fabric import duties, generally in excess of 20 percent. At the same time, they are more than adequately



compensated for this by much higher import duties on garments, generally in excess of 40 percent. The net effect is very high rates of effective protection when selling domestically.

#### 10. Why Does South Africa Want a Double Transformation Rule?

One stated reason for a double transformation rule for garments and other textile products is to encourage use of regional inputs. Under current practices, few, if any, South African garment exports would qualify under such a rule. What is the real reason, then, for South African insistence on this rule?

A more compelling reason is that South Africa currently imposes import duties in excess of 20 percent on most woven and knitted textiles. This imposes a large cost penalty on the South African garment industry.

Under current circumstances, South African garment makers are compensated in the domestic market by duties of 40 percent and more on garments – providing them with effective protection in excess of 70 percent on these sales. In export markets, they are compensated by import duty rebates, exemptions and DCCs.

In the event of tariff-free trade in SADC, however, and with a single transformation rule of origin, non-SACU garment makers in Member States with low or zero import duties on cloth would have access to the protected South African market without the cost-raising penalty of South African import duties on fabric. Against such competition, South African garment makers would face negative effective protection in the range of minus 50 percent.

The real reason, therefore, for South Africa's insistence on a double transformation rule of origin is the penalty it imposes on its own garment producers through its high import tariffs on fabric. Until South Africa further liberalizes its upstream textile and yarn sectors on an MFN basis, there will be strong resistance to a rule of origin that would give other Member States duty-free access to its garment market while using non-SADC fabric.

*The double transformation rule of origin is designed, not really to encourage use of regional textile inputs (not even South African garment makers do so at the moment), but rather, to ensure that SADC preferential trade does not take place when South African garment makers labor under their own government's policy handicap of high textile duties.*

The same explanation applies one stage further back in the production chain. As long as they are penalized by high duties and other restrictions on yarn and fibre imports, South African textile makers do not want duty-free competition from regional weaving and knitting industries that have access to duty free yarn. A double transformation rule of origin 'solves' this problem by ensuring that such competition will never occur.

This explanation is consistent with a slightly different version of the same story. When pressed about the rationale for a double transformation rule of origin, the South African industry often refers to the problem of 'illegal' imports. What garment makers are really concerned about are Asian-made garments that are imported as being made in, say, Malawi; and what fabric producers are talking about is Pakistani cloth imported as being made in, say, Mozambique.

In the absence of reliable customs enforcement of even a single transformation rule of origin, they would like to impose a requirement that could not possibly be satisfied in Malawi or Mozambique. That is, they would like to ensure that no legal preferential trade is possible. This makes the enforcement job of Customs relatively simple – all preferential trade that claims to meet the restrictive rules of origin is being conducted under false pretences; it is *a priori* 'illegal' and hence should not be granted SADC preferences.

While this rule might be easily enforced, it must be asked whether it is consistent with the spirit or intentions of the Trade Protocol. A rule which would have the effect of prohibiting preferential trade is difficult to reconcile with an arrangement designed to promote such trade.

In the event of SADC free trade, however, this protection would be eroded by SADC garment makers with duty free access to the SACU market and (depending on their own domestic import duty structures on fabric), zero or very low tariffs on imported fabric. Without lowering its own import duties on fabric, the only way South Africa could protect itself from such 'unfair' competition is

through a double transformation rule of origin, in effect requiring the use of high cost South African fabrics.

Since most South African garment makers cannot satisfy this rule of origin, it is highly unlikely that it could be met by non-SACU producers. The SADC double transformation rule of origin will prevent preferential intra-SADC garment trade, thus permitting South Africa to preserve its high protection policies on garments and fabric. It certainly will not promote intra-SADC trade in this sector – not even among non-SACU Member States. And it will do nothing to promote the global competitiveness of South African or other SADC textile and garment producers.

As observed earlier, SADC arrangements for the textile and garment sector were agreed prior to and without reference to AGOA. Will the Trade Protocol assist in taking advantage of this unique opportunity?

AGOA offers extended GSP privileges for a wide range of African products to the US market for the period ending in 2008. Among the most important sectors is textiles and clothing.<sup>9</sup> The typical U.S. MFN import duties on garments currently exported from the region are in the range of 17 to 20 percent.

On the other hand, the AGOA rules of origin require that most garments be made from yarn and textiles produced in the region or the US ('yarn forward' rule). This requirement is temporarily waived for the least developed qualifying countries, which will be permitted to source cloth anywhere for AGOA garment exports, but only until September 2004.

This rule of origin is a double-edged sword.

- In the absence of regional capacity to produce textiles of adequate quality, quantity and price, the rules of origin will prevent the region from taking full advantage of the AGOA export opportunities.
- On the other hand, the rules of origin provide a tremendous incentive to increase and improve regional capacities in textile production.

These rules of origin are exogenous to SADC Member States. They are the outcome of negotiations among conflicting US interests. On the one hand, garment buyers and American pro-Africa lobbies would prefer relatively unrestrictive rules in order to make Africa as low-cost a supply source as possible and to maximize the employment creating and development possibilities from access to the US market. On the other hand, American textile sector producer and labor interests prefer stricter rules in order to minimize African competition and consequent 'market disruption' in their domestic markets.

Limitations in regional yarn and fabric production capacities have already been identified as a serious impediment to the region's ability to take advantage of AGOA (Coughlin, Rubin and Darga 2001; Stern and Netshitomboni 2001). However, early AGOA experiences with Mauritian garment exporters and US garment buyers suggest that there is room for considerable regional collaboration among buyers, garment exporters and yarn and textile producers to develop regional capacities, especially among existing companies in South Africa (see Box 11).

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<sup>9</sup> In an analysis of possible opportunities provided to South Africa, Stern and Netshitomboni 2001 show that almost all goods currently exported from South Africa to the US that might be significantly tariff-constrained are in these sectors (Table 1).

### **11. Demand for South African Textiles – The Potential of AGOA**

Nothing illustrates better the potential of AGOA for promoting the development of regional textile production capabilities than the recent experience of South African textile makers in Mauritius.

According to the long-time head of a major Mauritian garment exporting company, in the 10 years prior to AGOA, he had never had any contact with even a single South African textile producer. Within three months of the signing of AGOA, he had received calls or visits from a dozen such producers.

A visit to the offices of a major US garment buyer in Mauritius tells the same story. Within months of the passage of AGOA, the company's meeting room and offices were lined with samples of fabric from South African mills. These products were being closely examined with a view to developing them for use in garments made in Madagascar, Malawi, Mauritius, and other regional centres for sale in the US under AGOA. The US buyers were working closely with these South African producers in order to help them develop the capability to meet the stringent standards of the US market. The same US buyers now have permanent offices in the factories of key textile producers in South Africa.

US buyers, together with garment producers in a number of SADC Member States and other countries in the region, have a very strong interest in seeing the South African textile industry achieve its potential to supply the US market.

These synergies are not related in any way to SADC rules of origin or other requirements. What is needed above all to capitalize on these new opportunities is ease of trade, transport and communication among SADC Member States (and with key non-members such as Madagascar). Tariffs, NTBs and bureaucratic regulations associated with rules of origin and other requirements of intra-SADC trade will hinder, not assist, in the exploitation of the job and wealth creating potential of AGOA.

International experience, most recently in Asia over the last two or three decades, suggests that the capacity to produce fabric of the high quality, low cost and reliable delivery under the tight time schedules demanded by US and European garment buyers takes a long time to develop. The demands that are being created by AGOA are a strong and very useful stimulus to develop these capacities in South Africa and elsewhere. But meeting the challenge will require an enabling policy environment and strong commitment by African and foreign investors. Success cannot be taken for granted.

AGOA rules of origin are beyond the influence of SADC Member States. However, the ability to create enabling domestic policy environments at the level of SADC and its individual Member States will play a key role in determining whether regional linkages do develop to their fullest potential in response to the AGOA opportunities (Coughlin, Rubin and Darga 2001). Minimizing fiscal, logistical and bureaucratic obstacles to intra-SADC trade must play a key role in creating the appropriate enabling environment.

Even without regional trade and cooperation there is still room for rapid mobilization of capacity to capitalize on opportunities in AGOA. Recently announced investments in weaving capacity in Lesotho are directly linked to AGOA opportunities. Even more impressive is the large new investment in an integrated spinning, knitting dying and finishing, and garment production by a Malaysian company, Ramatex, in Namibia (see Box 12).

### **12. Integrated Factory Complexes – An Alternative to an Integrated Region?**

Ramatex Bhd., a Malaysian textiles company, has recently undertaken a massive investment in an integrated spinning, knitting, dying, finishing and garment production in Windhoek, Namibia. The entire facility is aimed at accessing the U.S. market under AGOA.

Ramatex has a worldwide network of textile operations and has integrated operations of the type being built in Namibia in Johor Baru, Malaysia and Suzhou, China. The Namibian investment, however, is the company's largest factory complex in the world.

The company will produce a variety of types of clothing and sportswear in Namibia, and will sell the products through an established network of American customers. Related companies producing sportswear for global American sports brands will build adjoining factories that will utilize inputs produced at the main factory. The integrated nature of the operation will enable the factory to meet AGOA rules of origin from this one source. Fibre inputs, dyestuffs, finishing and other materials will be sourced from the company's global operations. As the operation matures, however, they will develop or encourage the development by others of local complementary activities such as packing materials.

Ramatex has several clothing factories in South Africa and had intended initially to build this new AGOA-directed complex on land it had purchased near these existing factories. But delays in development of the South African venture led the company to consider other locations, and Windhoek was the ultimate choice.

By the end of 2002 the complex will employ 8,000 to 10,000 workers. The factory will ship 300 to 400 containers of garments a month through Walvis Bay to the US market. By the end of January they had already trained over a thousand sewing machine operators, with the assistance of trainers from China, Malaysia, the Philippines and Singapore. Learning abilities and productivity of the new recruits significantly exceeded expectations.

Ramatex will supply fabric to its own garment factories in South Africa. It is discussing cooperation with a number of South African companies in the textile and garment sector. However, by the nature of its large, integrated operation, Ramatex will depend on and contribute only in a minimal extent to regional integration.

AGOA can produce significant growth and employment benefits for SADC Member States regardless of the success of SADC in achieving regional economic integration. But this approach has far less to offer to existing regional textile operations.

An ironic characteristic of these investments is the indication they provide that green field investments in upstream parts of the supply chain, the areas in which South Africa has until now been the dominant SADC player, are taking place outside of South Africa. The examples shown here indicate that South Africa, especially the spinning, weaving and knitting industries, has a great deal to gain from regional integration to take advantage of AGOA. By the same token, it could have the most to lose if this potential is not realized.

What can be concluded about the appropriate rule of origin regime for SADC in this sector? For export-oriented garment and textile production, any SADC rules of origin are:

- redundant in the face of restrictive rules imposed by AGOA (and EU) and/or
- unnecessary and almost certainly cost-raising where exports are not constrained by such rules in export markets.

The stringent rules of origin and backloaded tariff reduction schedules that are currently agreed for textiles and garments will be especially unhelpful to SADC as a means of taking advantage of AGOA.

To take advantage of international export opportunities, producers at any place in the garment and textile value chain would benefit from as much flexibility as possible in sourcing raw materials and intermediate inputs. Constraints that have any effect on these choices increase costs and hence reduce international competitiveness in one of the most demanding and competitive sectors of global trade.

When constraints on input sourcing are externally imposed, as with the AGOA rules of origin, duplication of these requirements through domestic or SADC-wide rules simply imposes additional barriers to interregional cooperation and integration that might assist in meeting the international rules. SADC's current double transformation rule hinders rather than promotes regional integration (see Box 10).

For regionally-oriented garment production, the restrictive SADC rules of origin will achieve the opposite of what is intended. They hinder rather than promote regional vertical integration. They

restrict tariff preferences only to integrated spinning and weaving/knitting operators that operate in Member States with high MFN tariffs on these products (See Box 5 in Flatters 2002b). And they impose conditions on garment producers that cannot be met even by South African garment makers when producing for their own highly protected domestic market (Box 9).

The real purpose of the current rules of origin is to ensure that South African producers face no competition from non-SACU SADC producers. This is motivated, in turn, by the heavy cost penalties imposed by South Africa's protective MFN tariffs on raw material inputs (Box 10).

Any Member State that finds its MFN tariff schedules inconsistent with the liberalization of intra-SADC trade should delay its tariff phase-down until it has adjusted its MFN tariffs appropriately. The use of rules of origin to ensure that preferential tariff reductions will have no impact yields policy confusion and worsens rather than improves the trade policy environment. A simple change of tariff heading rule is all that is needed as a SADC rule of origin at all stages in the textile and garment value chain.

The Trade Protocol in this sector has been dominated by the inward-looking, fortress vision of SADC. Without a rapid and convincing change in this vision, the SADC textile and garment sector will cripple itself by removing a vehicle for capitalizing on the unique and time-limited opportunities offered by AGOA. Taking advantage of AGOA will be difficult in the best of circumstances. To try to do so in the face of self-imposed policy handicaps is a self-defeating way to try to meet the challenge.

#### **4. How Did We Get Here?**

SADC's complex and restrictive rules of origin will impede regional integration and will be at best irrelevant in improving the international competitiveness of regional producers. They will delay the integration of Member States into the global economy. Why did the negotiation process stray so far from its initial goals? Among the more important reasons were misunderstandings of the effects of restrictive rules of origin, capture by special interests, and lack of support for trade liberalization.

##### **4.1 Misunderstandings**

The greatest misunderstandings concern the protective role of rules of origin. Under the made-to-measure approach, many negotiators treat rules of origin as instruments of industrial development. It is assumed that more restrictive rules are better, since they encourage greater use of regional raw materials. And it is felt that opening preferential trade to producers using low levels of regional content will undermine those using higher local content. These assumptions are incorrect.

Negotiators were surprised to discover, for instance, that South African producers in a wide range of industries, even those with high levels of local and regional content, saw no advantage in strict rules of origin. While valve producers and manufacturers of small and large electrical appliances prefer to source locally whenever possible, the flexibility to source from the best international source is an important determinant of their global competitiveness. South African garment makers supplying to large regional retail chains would go out of business if they were required to source cloth locally or regionally.

The flexibility to source internationally does not stop any of these producers from developing regional supply networks. The logistical cost advantages of doing so are obvious. But government requirements to do so would not help; they would reduce rather than increase their international competitiveness.

Food processors have a similar incentive to source locally. But the need for variety and for materials that are available only in certain parts of the world is essential in many blended products. And even with locally available raw materials, unexpected market disruptions make international sourcing a

critical safety valve. Flexibility in the international sourcing of raw materials is a key to competitiveness.

Reducing the competitiveness of processors and manufacturers ultimately harms input suppliers. And input suppliers that sell in world markets and divert some production to local buyers as a result of restrictive rules of origin will not gain in terms of volume or value of sales.

Officials sometimes wish to 'protect' firms that do not exist or those with minimal numbers of jobs at stake. South African negotiators advocated restrictive rules of origin for a domestic industry with two firms, one that is globally competitive and has no interest in restrictive rules, and another that has already shut down. Mauritian negotiators almost did the same for an appliance assembler that had already stopped a minimal CKD assembly operation employing fewer than 20 workers, and for heavily protected CKD motorcycle assemblers employing about 12 workers (see Box 7 above).

#### **4.2 Capture by Special Interests**

Trade negotiations attract rent seekers. This is especially true of regional agreements in markets that are not very competitive. In such conditions tariff reductions can create large profits for one or two players, sometimes at the expense of regional competitors and always at the expense of regional consumers.

SADC wheat flour markets are dominated by a few major players. Several Members proposed a rule of origin requiring use of local wheat for flour to qualify for SADC free trade. South Africa argued that its tariff on wheat would make it impossible for their millers to compete with other SADC millers that can buy wheat at world prices. However, not even South Africa produces enough for its own consumption needs. The proposed rule of origin would bar all but South African millers from the benefits of SADC free trade.

In fact, South African wheat duties have no cost-raising effect on domestic wheat prices. South African grain growers receive an export parity price in the local market, making wheat so inexpensive that some non-South-African millers buy in South Africa.

While negotiators talk of protecting wheat farmers against subsidized international wheat, the proposed rule of origin actually would confer monopolistic SADC market access and hence substantial profits on one group of SADC flour millers, with no benefits to grain growers or to consumers of bread and other flour products.

#### **4.3 Lack of Commitment to Trade Liberalization**

Some negotiators remain committed to protection as a development tool. They see SADC as a way to broaden a protected market, not as a platform for increasing competitiveness in global markets.<sup>10</sup>

This vision creates problems for regional trade liberalization. South Africa's textile and garment industry has developed under a system of cascading tariffs, with typical rates of 10 to 15 percent for yarn, 20 to 22 percent for fabric and 40 to 44 percent for garments. Many other Member States have lower import duties, especially on yarn and fabric, with garment exporters generally having access to duty free fabric.

Freeing of SADC trade in garments would expose South African garment makers to strong competition from other Member States with access to internationally priced cloth. The proposed solution is a rule of origin requiring the use of regional cloth to qualify for SADC tariff preferences – a requirement that most South African garment makers could not satisfy. However, not even this

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<sup>10</sup> See Flatters 2001 for a discussion of alternative visions of SADC and their implications for implementation of the Trade Protocol.

restrictive rule would solve the South African industry's problems. South African fabric makers also fear competition from regional weavers with access to duty free international yarn.

Because of its high and cascading tariff structure, therefore, South Africa insists on a 'yarn forward' rule of origin, requiring that all downstream textile and garment products be made from regional yarn and regional fabric. South Africa will agree to regional free trade only if regional competitors forego access to almost all international inputs.

This would tie SADC-oriented producers to production patterns that are completely different from those of internationally competitive producers elsewhere. To participate in SADC, they will have to adopt production patterns that would cripple them in global markets.

The protectionist approach to development denies the need to be geared to international competition. Trade liberalization, on the other hand, is based on free access to imports and exports to capitalize on local advantages and maximize opportunities for growth. As long as some Member States insist on pursuing protectionism, rules of origin will be used to frustrate the integration of SADC into the world economy.

## 5. What Should Be Done?

Negotiation of rules of origin reveals fundamentally different visions of SADC. If rules of origin are used simply to authenticate whether imports arise from substantive economic activity in the region, SADC could help promote regional trade and international competitiveness of Member States. If they are used for protection or for social and economic goals that can be better achieved by other means, SADC might be at best irrelevant for the region's development.

Rules of origin are required in order to authenticate that goods trading under SADC preferences actually are the result of economic activity in the region. SADC trade negotiators initially agreed on a simple and transparent set of rules for this purpose. They later chose to burden rules of origin with responsibility for a variety of goals that could be achieved much better through other means, and to employ them as instruments of protection, thus undermining the principal goal of the Trade Protocol.

This change in direction in the use of rules of origin was the result of some fundamental misunderstandings of their economic impacts, capture by rent-seeking vested interests, and insufficient commitment to trade liberalization.

The current rules of origin in SADC will hinder regional economic integration and, at best, have no impact on global competitiveness of regional producers. They make SADC irrelevant for the most dynamic, internationally competitive manufacturers in the region. In many cases rules of origin have been designed to undo the trade creating effects of tariff liberalization.

Member States interested in improving their global competitiveness face a choice.

- They can go it alone – an approach that has worked for Mauritius for several decades and that is beginning to reap returns elsewhere in the region. This would mean a continuation of non-preferential trade liberalization and domestic regulatory reform to improve their domestic investment environments. It requires minimal coordination among SADC neighbors.
- Or they can use the scheduled review in 2004 to re-examine rules of origin and other weaknesses in the Trade Protocol. This should include a serious examination of the effects of the Trade Protocol on the region's global competitiveness and investment environment. It would require the flexibility to acknowledge previous mistakes, and to remedy them quickly. In so doing, Members should recognize this as a complement to continuation of unilateral measures to enhance competitiveness.

Without fundamental reform, SADC is doomed to economic irrelevance.

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