The role of Rules of Origin in promoting industrialisation

OVERVIEW

This policy brief investigates the issues of rules of origin (RoO), their implications in a free trade area, and their role in promoting industrialisation and forging regional value chains (RVCs) under the African Continental Free Trade Area (AfCFTA) agreement, with the main focus on the cotton and textile and clothing sector. The policy brief first looks at the cotton to textile and clothing value chain, including the general cost drivers at each segment of the value chain, which have major implications on the productive and industrial capacities of countries. Second, it looks into the purpose of the RoO in the AfCFTA and its impact on intra-regional trade flows and the way the set policies can affect regional integration and the RVCs. Last, possible applications of the RoO, their implications for industrialisation in the AfCFTA, and the approaches by industry and governments are laid out.

Trade & Industrial Policy Strategies (TIPS) is a research organisation that facilitates policy development and dialogue across three focus areas: trade and industrial policy, inequality and economic inclusion, and sustainable growth

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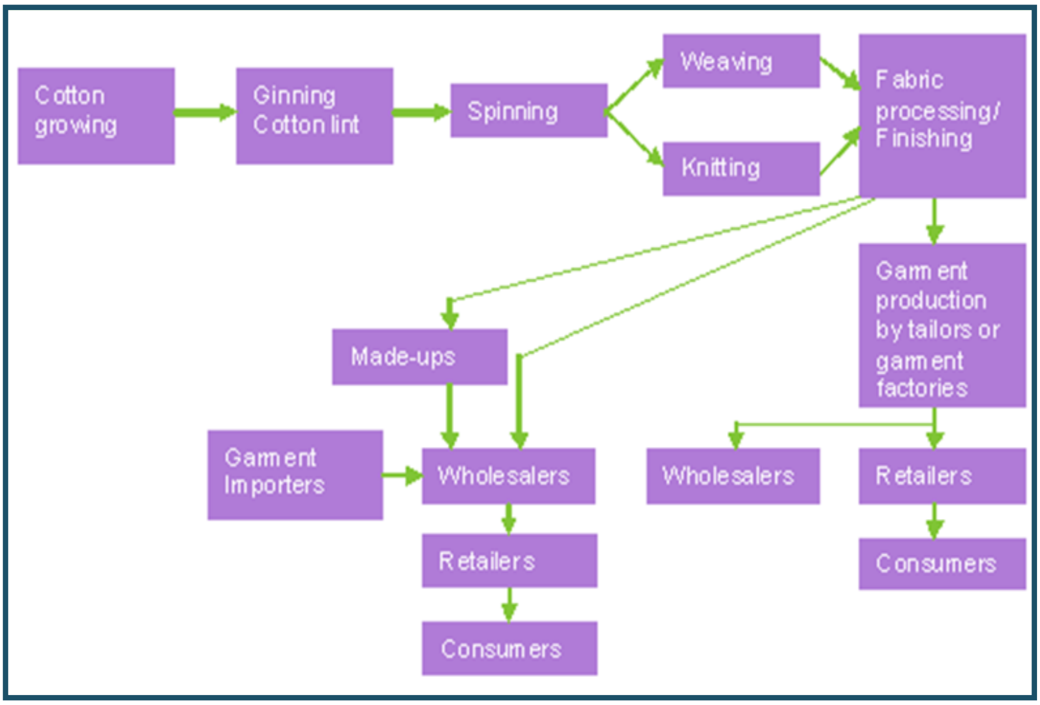
THE COTTON TO CLOTHING VALUE CHAIN

The cotton to textile and clothing value chain, as elaborated in Figure 1, starts at farm level with the growing of cotton. The two major inputs of production are labour and agro-chemicals. In terms of costs, labour is very cheap, but quality and productivity are often low while chemical inputs tend to be expensive. Cotton can be grown either as organic or non-organic. The second stage is ginning, when lint is separated from seed.

The cotton is then baled and goes for spinning to produce yarn. The yarn goes on for weaving or knitting, depending on the desired end product. Weaving and knitting depend on a factory-based system and the key aspects of processing are energy, labour and machinery. The finished fabrics are assembled for wholesale or retail customers and sold locally or exported (ITC, 2011). The fabric is further manufactured into garments (textile or clothing) that are also assembled for wholesale or retail customers and sold locally and/or exported.

Figure 1: The cotton to clothing value chain



Source: Adapted from the COMESA Regional Strategy for Cotton – To – Clothing Value Chain. Page 6.

Africa is not globally competitive in textiles and clothing exports. Africa's share of global textiles and clothing exports accounted for 2% in 2020, a reduction from an average share of 3% between 1995 and 2009.

The different parts of the cotton to textile value chain are both labour- and capital-intensive as well as energy intensive. This means that the cost of labour, its quality and productivity; investment in machinery; and reliable and cheap sources of energy are the key drivers of the industry. At the more industrialised level of the value chain, the textile and clothing manufacturing sector absorbs predominantly women workers.

The International Trade Centre (2011) states that, "the objective of regional integration is to create a regional supply chain so that the most efficient and cost-effective regional producer and supplier of all the stages above integrate into one efficient regional supply chain. The ability to do this depends on a series of factors such as transport, government protection, local demand, and the basic knowledge of who does what in the region." African countries taking part in the cotton to textile and clothing value chain are diverse and have a comparative advantage at different segments of the value chain, creating the potential for the deepening of regional integration on the African continent and thus stimulating growth and increased welfare.

Cotton

Cotton exports from Africa are dominated by West African countries such as Benin, Burkina Faso and Mali, and Egypt. Cotton is mostly exported in raw form. Africa's exports of raw cotton account for 10% of the global raw cotton exports (HS 5201), with Benin, Burkina Faso and Egypt accounting for nearly 50% of raw cotton exports in 2020 (ITC Trade Map). Sixty percent of the cotton exports goes to the Asian market. By region, the top exporters of cotton are from West Africa with 71%, followed by Northern Africa with 13%, and then Middle, Eastern and Southern Africa with 8%, 6% and 2% respectively (Mold and Chekwoti, 2021).

The global exports of raw cotton are dominated by the United States (US), followed by Brazil, India and Greece with 42%, 23% and 16%, respectively, and 3% each for Greece and Benin, in 2020. In terms of employment, it is estimated that 450 000 Africans work in the cotton sector (Mordor Intelligence, 2021), mainly in West Africa.

Although cotton faces growing competition from synthetic fibres, it is still important and making its mark in the global fashion as well as linen industries.

In terms of prices, global cotton prices reduced by 13% in 10 years between 2010 and 2020 from US$1 778 to US$1 542. They declined around 40% between 2011 when they were at their highest (U$2 569) and 2020 (ITC, 2021).

The farmers bear the brunt of the reduced prices and price volatility in the global market more than the ginning companies and the traders. In addition, the African cotton farmers are negatively impacted by the heavy import duties by cotton importing countries such as China.

Textiles and clothing

Asia leads the global exports of textiles and clothing with the top four exporters being China, Bangladesh, Vietnam and India, accounting for 40%, 5%, 5% and 4% respectively in 2019. It is followed by the European Union (EU) with Germany and Italy leading with 5% and 4% respectively in the same year and other EU countries hovering between 1% and 2%. The US follows with 3%.

In contrast, Africa is not globally competitive in textiles and clothing exports. Africa is characterised by small-scale suppliers that are unable to meet the requirements of the large global buyers, hugely surpassed by the Asian counterparts which operate large volume plants and multinationals. Africa's share of global textiles and clothing exports accounted for 2% in 2020, a reduction from an average share of 3% between 1995 and 2009 (UNCTAD, 2021). The major exporters of textiles and clothing are Morocco, Egypt and Tunisia. Together they account for around 65% of the total textile and clothing exports.

Textile and clothing prices have been trending downwards since the mid-1990s due to high competition (Mold and Chekwoti, 2021). Western Europe and North America together account for over 60% of global consumption. The leading global importers of textile and clothing are the US with 15%, Germany with 7%, United Kingdom, France, Japan and China, all at 4% in 2020. The major importers of textile and clothing in Africa are Egypt, Morocco, South Africa and Nigeria, accounting for 13%, 11%, 11% and 10% of the Africa's total imported textiles and clothing.

A positive trade balance for Africa was last seen in 2004 at US$1.6 billion. This worsened from a deficit of US$1 billion in 2005 to $11 billion in 2020. Despite the negative aggregate trade balance, African countries are making efforts to improve their industrial capacities mostly under bilateral and regional trade preferences. Most countries have taken advantage of the trade preferences under the Africa Opportunities and Growth Act (AGOA) to increase their export capacities.

The aim of the AfCFTA agreement is to improve the socio-economic development of Africa; to enhance the ease of doing business; and to set the continent on the path to industrialisation over the next 30 to 40 years.

THE AFRICAN CONTINENTAL FREE TRADE AREA AND RULES OF ORIGIN

The AfCFTA agreement

African countries entered into a free trade agreement, the African Continental Free Trade Area (AfCFTA), in 2019, drawing its membership from 55 countries. AfCFTA connects 1.3 billion people across Africa with a combined gross domestic product (GDP) valued at US$3.4 trillion. The aim of the AfCFTA agreement is to improve the socio-economic development of Africa; to enhance the ease of doing business; and to set the continent on the path to industrialisation over the next 30 to 40 years (Mene, 2021). The AfCFTA has the potential to lift 30 million Africans out of abject poverty and 68 million Africans out of moderate poverty by 2035 (UNCTAD, 2021).

The rules of origin under the AfCFTA

The AfCFTA was to have been legally implemented from January 2021. However, this has not created actual trade flows under the AfCFTA preferential tariff schedules due to the outstanding negotiations on the RoO, which is essential to enabling trade flows within the continent. Rules of origin determine the national source of a product and the product's eligibility for preferential tariffs under a free trade agreement. The RoO in the AfCFTA are important as they are viewed as essential to strengthen the relationship between trade and industrialisation: they are meant to encourage value addition of Africa's commodities within the African continent. In addition, they serve to prevent trade deflection and transshipment[1] of goods from third countries into the AfCFTA with no or insufficient local value-adding activities having taken place on the African continent. In essence, they should be adequately designed to protect the African market.

In practice, firms choose to comply with RoO and use trade preferences when the benefits of trading under an agreement, determined primarily by the preference margin, are higher than the costs of complying with RoO. The compliance costs include the higher costs of sourcing products from within the free trade area and from certification requirements of the RoO (Signe and Maden, 2020).

From 1 August 2021, the agreed rules percentage coverage under the AfCFTA was 86.06%. The textiles and clothing sector, Chapter 51 to 63, accounts for 10.54% of the total 13.94% outstanding rules, indicating the significance of the sector within the African countries. The delay to conclude the RoO thus delays the freer flow of trade between member countries. In the meantime, Member States are expected to apply the preferential RoO covered by their relevant Regional Economic Communities (RECs) (Ndonga, 2021).

One of the reasons cited for the delay in achieving consensus on the RoO in the AfCFTA is the existing diverse RoOs used in the RECs, and the differing levels of industrialisation in the textiles and clothing sector among countries on the continent.

The AfCFTA has to be seen to be stimulating trade within the continent and building capacities for the development of the RVCs. At present, overall intra-African trade – the average of intra-African exports and imports – is very low, estimated at around 15% between 2015 and 2017, compared with 67% in Europe, 61% in Asia and 47% in America for the same period (UNCTAD, 2019).

There is a wide disparity among African countries in the cotton to textiles value chain. By region, intra-African trade in the textiles and clothing sector is highest in Southern Africa at 22% followed by very low intra-Africa trade within Northern, Eastern, Western and Central Africa of 4%, 3%, 3% and 1%, respectively in 2020.

The RoO applied in different trade agreements (whether within the continent or with third countries), and the countries' different levels of regional integration, productive capacities and industrialisation play an important role in these different levels of intra-regional trade. For instance, countries such as Kenya, Lesotho, Ethiopia, Mauritius, Madagascar, Tanzania and Ghana, among others, have managed to take advantage of preferential tariffs offered by the United States under AGOA, exporting apparel to the US, and have also been able to source some of their inputs from other African countries. While participation in AGOA has been beneficial in creating jobs in these African countries there are many concerns about the inability of AGOA to support Africa's industrialisation and regional value chains.

Under the agreement establishing the AfCFTA, tariffs on 90% of tariff lines are expected to be eliminated over a period of five years for developing countries, and up to 10 years for least developed countries (LDCs), making it possible for the business community

[1]*Third countries benefitting by exporting their products to the continent using the preferential tariffs intended to benefit the countries within the AfCFTA without any form of transformation locally.*

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in the region to increase economies of scale through access to cheaper raw materials and intermediate inputs (Ndonga, 2021).

It is anticipated that by 2035, 97% of African trade will be at zero duty – based on the RoO that are being agreed at present.

APPLICABLE RULES OF ORIGIN AND THEIR IMPLICATION ON INDUSTRIALISATION

The negotiations on the RoO for textiles and clothing under the AfCFTA are centred around flexible and more stringent rules, depending on the industrial capabilities and capacities of member countries.

An agreement has to be reached for each tariff line of Chapters 50 to 63 on the level at which inputs must be transformed for them to confer origination. The Kyoto Convention divides products into two categories, the wholly obtained products and those that need substantial transformation to be considered originating. The levels of transformation and their implications on industrialisation are discussed in the following sub-sections.

Single transformation

It is argued that the single transformation RoO, or a simple value addition threshold of 35% or a change in tariff heading, makes it easy for products to qualify for FTA treatment. It therefore attracts market-seeking domestic, regional and foreign investment into the textile and clothing sector; it increases intra-regional trade; and promotes industrialisation and creates jobs. The challenge is that such low thresholds often attract simple assembly industries which do not promote industrialisation and could encourage transshipping.

Some writers argue that one of the options applicable is to adopt change of tariff heading with a transition period, within which the countries should build the capacities to industrialise before moving to more stringent rules. This view is criticised by those writers that are concerned to promote industrialisation and prevent the deindustrialisation of other African countries due to cheaper imports that displace domestic intermediate product producers, such as textiles and other parts such as zips and buttons. It is also argued that the transitional product-specific RoO create uncertainty for business, investors and firms (Inama, 2021).

Double transformation

The double transformation RoO is usually favoured by those most concerned with the promotion of industrialisation, as it is preferred for enhancement of backward and forward linkages of regional value chains. Single transformation, it is argued by these writers, creates a situation in which fabrics are imported from third countries to be simply cut and knit, and tends to destroy local fabric production, and in some cases also amounts to theft of intellectual property rights, for example of African designs by third countries.

Triple transformation

The argument for triple transformation is that Africa produces sufficient cotton (fifth largest global producer), to supply its textile and clothing industry, to promote backward and forward linkages and RVCs, and to increase intra-Africa trade and industrialisation.

Approaches by industry and governments

African countries have argued for lenient and less-demanding rules of origin in preferential schemes with third countries, such as AGOA, in order to promote preference utilisation. Some industry representatives have advocated strongly for the third-country fabric provision under AGOA and a simple change in tariff heading for REC RoO. Thus African governments have argued for lenient rules in preferential arrangements with third countries.

However, some African governments have sought more stringent rules in REC (such as the Southern African Development Community – SADC) regimes to promote local sourcing and therefore industrialisation.

This experience of RECs indicates that double or triple transformation of RoO, that are argued for structural transformation and industrialisation, cannot be simply achieved by their mere application. Industrial policy needs to be accompanied by a range of complementary support, such as technology and industrial upgrading; branding and fashion; digital trade; affordable and accessible finance; market intelligence for trade and investment opportunities; agglomeration and clustering; extension services; and training and skills development. In addition, countries could build a work programme or sector pact on cotton, textiles, clothing and retail to support their industrialisation programmes.

It is important that the Rules of Origin ensure inclusivity and fuller participation in the benefits from the AfCFTA, especially for the smaller and weaker economies in Africa.

Utilisation

Businesses are more able to utilise preferential tariffs under the FTAs if they are easy to use, transparent and cost-effective because they contribute to building their local, regional and global competitiveness.

In practise, the level of utilisation of the existing RoO on different products under the textiles and clothing sector have generally been low, with varied levels of utilisation by countries in different RECs. This low utilisation rate has also been observed in the experiences of African countries with the preferential trade agreements, such as AGOA, and the EU Cotonou preferences.

CONCLUSION

Various issues come into play when negotiating the RoO. It is imperative that the RoO are properly designed and implementable for them to serve their purpose. When negotiating the RoO, the Member States need to consider all the bottlenecks impeding intra-African trade along the cotton to textile and clothing value chain. It is critical to draw lessons learned from the RoO that have been applied in the existing RECs within the continent and from other regional trade agreements such as the EU, the Association of Southeast Asian Nations (ASEAN), Central America Free Trade Agreement CAFTA, and North American Free Trade Agreement (NAFTA). In addition, preferential trade agreements such as AGOA should be studied, taking into consideration the extent of utilisation of these rules. It is critical that the agreed RoO on cotton, textiles and clothing in the AfCFTA facilitate the promotion of trade and industrialisation and take advantage of the disruption in global supply chains as a result of the COVID-19 pandemic.

As countries are at different levels of industrial capacity, it means some countries will be immediate beneficiaries and will be able to immediately export because of their more advanced productive capacity, while others may take a much longer time to build their productive capacity. It is therefore important that the RoO ensure inclusivity and fuller participation in the benefits from the AfCFTA, especially for the smaller and weaker economies in Africa.

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