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SADC Rules of Origin: Impediments to Regional Integration and Global Competitiveness

The SADC Free Trade Agreement, which came into being at the beginning of 2000 is up for a mid term review during 2004. The agreement is characterised by complex and restrictive rules of origin. Using references to case studies, Frank Flatters argues that if rules of origin were used simply to authenticate whether imports arise from fundamental economic activity in the region, SADC could help promote regional trade and international competitiveness of Member States. If they continue to be 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.

With a few exceptions, Sub-Saharan Africa has failed to benefit from globalisation. Following a decade or more of liberalisation and policy reform, however, regional players are now becoming competitive in international markets. This promises new investment, employment growth and skill enhancement, essential foundations of development.[1]

SADC Member States have chosen regional integration as part of their strategy for global participation. While not the best strategy, regionalism can complement more general trade and investment liberalisation. Whether this happens depends on the vision guiding regional integration.[2]

The SADC Trade Protocol, unfortunately, is flawed. Well-known problems are back-loaded and confusingly differentiated tariff reduction schedules. Less clearly understood are the effects of complex and restrictive rules of origin.

SADC rules of origin will hinder regional economic integration and have no impact on global competitiveness of regional producers. In many cases, rules of origin have been designed to undo the trade creating effects of tariff liberalisation.

Why Rules of Origin Are Needed

Rules of origin are essential in any preferential trade arrangement (PTA). They are necessary to authenticate that goods entering a Member State's market truly originate in a country that qualifies for preferential tariff treatment. Without rules of origin, PTAs would be subverted by tariff-jumping or trade deflection. The absence of rules of origin would also give rise to illegitimate trans-shipping of goods into the PTA area through a low tariff Member State to avoid higher external duties imposed by another Member. The importance of rules of origin increases with the level and with the variance of external tariff rates among Member States.

Authentication is achieved by requiring minimal levels of regional economic activity to qualify for tariff preferences. In SADC, as in most other PTAs, this is done in two ways:

- By disqualifying goods that have undergone only simple repackaging, labelling, mixing and other “screwdriver” operations within the PTA and
- By requiring minimal levels of economic activity in regional production, as measured by some or all of:
    - I) one or more change of tariff heading,
    - ii) a minimum proportion of regional value-added in production,
    - iii) a minimum proportion of inputs sourced within the PTA, and
    - iv) the undertaking of specific processes within the region, including of course goods that are wholly produced regionally.

The SADC “screwdriver” rule applies across all sectors. This should allay concerns about “screwdriver” production that might undermine high cost producers in protected local markets.

The regional content rules, originally agreed for 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. This led to 'made-to-measure' sector-specific rules that are far more restrictive than originally agreed upon. The rules are now remarkably similar to those in PTAs with rich, highly industrialised countries, especially those in the South Africa-EU trade agreement.

The entire SADC market, including South Africa, is smaller than Turkey, and its industrial structure is relatively undiversified and technologically unsophisticated.[3] By exploring some of the justifications and misunderstandings behind the SADC rules, the use of developed country rules of origin is inappropriate and costly.

Other Uses of Rules of Origin

Rules of origin are needed for one reason only to authenticate whether imported goods are the product of substantive economic activity in the region. Nevertheless, policy makers and special interests have found many other uses for them. We group these into three categories: protection, other social purposes, and customs administration.

Protection

Rules of origin can protect regional industries and activities by encouraging the use of regionally sourced inputs. They can protect in two ways:

- High regional input requirements induce users to source in the region. However, if the incentives are effective, the producers change their sourcing behavior i.e. they raise their costs or use inputs they would not normally use. While this might give them access to the regional market, the same behavior decreases their international competitiveness. Furthermore, such rules are often of no benefit to input producers, especially of primary products whose prices are determined in world markets. For example: High regional sourcing requirements for coffee beans harm coffee processors that rely on worldwide sourcing for blending purposes. Even if the rules increased regional demand for local coffee, growers would simply switch their sales from international to regional markets, with no effect on the price of their beans or on their net incomes.[4]
- By raising costs and/or restricting input choice, restrictive rules of origin reduce the competitiveness of regional producers in the markets of other Member States. A rule requiring Malawian garment producers to use high priced regional fabric (usually South African) will hinder them from competing in South Africa.

The unintended impact of restrictive rules of origin is to raise costs and prices of traded goods, impede regional trade creation, and deprive consumers of the benefits of SADC free trade.

These higher costs reduce the competitiveness of downstream producers and make SADC irrelevant for internationally competitive producers. Studies of exporters in sectors, from water valves to small and large electrical appliances, from food processing to garments and textiles, yield a strong and consistent conclusion flexibility in sourcing of raw materials is a key to international competitiveness. No matter how high their current regional content, and regardless of the share of exports in total sales, producers prefer simple and unrestrictive rules of origin. Restrictive rules do not help internationally competitive firms. They make SADC irrelevant for the region's most dynamic producers.

Other Social and Economic Uses

Restrictive rules have been advocated for many purposes. This includes environmental protection, industrial and consumer safety, and prevention of dumping by regional or international producers. Denial of SADC preferences on the basis of regional content of imports, is a poor and usually ineffective means of achieving these purposes. Far more effective tools are available that have none of the harmful side effects of restrictive rules of origin.

Weak Customs Administration

Regional Customs administrations are said to be incapable of enforcing rules of origin. 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. The suggested solution are more restrictive rules of origin. However, why should a weak administration be more capable of enforcing restrictive rules than less restrictive ones?

Regional producers, in fact, could not satisfy the restrictive rules that are proposed. 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 liberalisation process. Why not improve administrative systems and capabilities?

How Did We Get Here?

The SADC rules of origin will impede regional integration and reduce international competitiveness of regional producers. The rules 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 liberalisation.

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. It is also 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. 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. 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.[5]

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 from South Africa.

While negotiators talk of protecting wheat farmers against subsidised international wheat, the proposed rule of origin would actually 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.[6]

Lack of Commitment to Trade Liberalisation

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.

This vision creates problems for regional trade liberalisation. 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 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.[7]

The protectionist approach to development denies the need to be geared to international competition. Trade liberalisation, on the other hand, is based on free access to imports and exports to capitalise 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.

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 fundamental 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 irrelevant for the region's development.

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 liberalisation and domestic regulatory reform to improve their domestic investment environments. It requires minimal coordination among SADC neighbours.
- 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 sector studies to examine the effects of the Trade Protocol on global competitiveness and the regional investment environment. It would require the flexibility to acknowledge previous mistakes, and to remedy them quickly. In so doing, Members should recognise this as a complement to continuation of unilateral measures to enhance competitiveness.

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End Notes

[1] For discussions of the links between global participation, development and poverty reduction see Flatters 2001c, Sachs and Warner 1995, Secretary of State for International Development 2000, and World Bank 2001.

[2] See Flatters 2001a and 2001b.

[3] See Flatters 2001a and 2001b.

[4] Because of SADC's small size in world markets, changes in SADC demand have no appreciable effect on world prices.

[5] For more details on the cases and issues discussed in this section see Flatters 2002a.

[6] See Flatters 2002b for more of rules of origin in this sector.

[7] For more on rules of origin in textiles and garments see Flatters 2002c.

Bibliographical Note

Frank Flatters is Professor of Economics, Queen's University, Canada. This article is a summary of research prepared for the USAID-funded SADC Secretariat Project. Views expressed are those of the author and do not necessarily reflect those of USAID or the SADC Secretariat. Comments are most welcome. Please contact ff@thai.com.