

# **Rules of Origin and AGOA: Hard Choices for Textiles and Clothing in SADC**

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## **Rules of Origin and AGOA: Hard Choices for Textiles and Clothing in SADC**

### **Summary**

A number of recent market-opening measures in major developed country markets, especially AGOA, present a unique and time-limited opportunity for southern African economies to benefit from large increases in investment and employment in the textile and garment sector. This could redress past failures of many countries to participate fully and competitively in global markets.

Regulatory reform and liberalization of trade and investment over the past decade have increased the attractiveness of southern Africa as an investment location. American garment buyers support AGOA because they see southern Africa as a competitive source of supply for the US garment market. Further liberalization and integration in SADC could increase the region's attractiveness.

The rules of origin imposed by AGOA – essentially yarn-forward as a requirement for almost all garment exports, with a brief window during which the poorest eligible countries will face a less restrictive single transformation rule – are a double-edged sword. On the one hand, they are very demanding and will be difficult to meet under the best of circumstances. This is primarily because of the underdevelopment of many of the relevant parts of the spinning, weaving and knitting sectors in SADC. On the other hand, they provide a strong incentive for the rapid development of these sectors.

There are two ways in which these demanding AGOA requirements might be met.

One is through investments in integrated facilities that can produce most or all of the elements in the value chain required to meet the AGOA rules. This has already begun. Experience so far indicates that these investments are most likely to take place in low labor cost locations – i.e. outside of South Africa.

These kinds of investments put minimal reliance on SADC regional integration. They rely on the ability of individual countries to provide a trade- and investment-friendly regulatory environment, as Mauritius has done over the past couple of decades.

The second way to meet the AGOA requirements is through further development and integration of existing regional capacities. This would mean expansion of spinning, weaving and knitting capacities in South Africa and to a lesser extent Mauritius, as a source of input supply for increased garment producing capacity in lower labor cost locations, as has happened on a very large scale recently in Madagascar.

The SADC Trade Protocol could play a key role in promoting regional integration to take advantage of AGOA. Unfortunately, the main features of the Trade Protocol were determined prior to and without reference to AGOA. As a result, the phase-in of tariff reductions, and the determination of rules of origin were guided by a 'fortress vision' of SADC – a vision guided by preferential access to slightly expanded but still heavily protected local and regional markets. The Trade Protocol was not driven by a vision of SADC as a platform for increased competitiveness in global markets.

Most SADC textile and garment industries are protected by high import duties. Under the terms agreed in Trade Protocol, the phase-in of preferential tariff reductions is heavily back-loaded. Furthermore, out of a fear of indirect competition for its protected textile industry South Africa has insisted on rules of origin for intra-SADC preferential trade in garments that cannot be met by most of its own producers, let alone its SADC trading partners. While it is argued that the cumulation provision under these demanding rules of origin will encourage regional textile industries, they will be

of no use except for fully integrated spinning and textile operations operating in a single Member State.

For SADC integration to support AGOA-related investment, regional trade in garments, textiles and yarns must be as free as possible. Since the AGOA window is time-limited, delays will be equivalent to shutting the door on this opportunity.

The real challenges lie beyond AGOA, after the special access period is over. Whether or not AGOA is helpful, the goal must be to be able to compete on an even footing with producers around the globe that soon will be unfettered by quota restrictions held over from the Multi-Fiber Agreement and other restrictive arrangements.

SADC and AGOA can both help; but in the end the challenges must be met by the actions of individual countries and any groups of countries that make special arrangements to facilitate trade in the textile and garment value chain. If SADC fails, the costs will be borne by workers in Member States. The biggest foregone investment and employment opportunities are likely to be in South Africa.

To use SADC as a platform for taking advantage of AGOA requires abandoning the 'safe haven' of protected markets that so far has been preserved under the Trade Protocol. Leaving this shelter is seen, quite rightly, as risky. But the risk of failing to take advantage of the foothold in world markets offered by AGOA is also large.

The choice is whether to remain inward looking – and miss another opportunity to participate competitively in world markets – or to take the plunge and exploit the unique advantages and challenges provided by AGOA. To some this might seem like a hard choice. To others, there might appear to be no choice at all.

## **Rules of Origin and AGOA: Hard Choices for Textiles and Clothing in SADC**

### **1. Introduction**

With the exception of a few countries, most notably Mauritius, and more recently Madagascar, sub-Saharan Africa has not been a major player in international textile and clothing markets. 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.

Do regional trade integration and other forms of policy coordination through SADC offer vehicles to take even greater advantage of the new opportunities? This depends on how the SADC Trade Protocol is actually implemented. Under certain conditions, SADC offers the possibility of achieving considerably more than could be gained by Member States acting on their own.

However, many Member States could accomplish a great deal for their citizens without any serious participation in SADC. Are investments in SADC-based policy initiatives worth the effort of individual Member States? This depends very much on how SADC is framed and implemented.

### **2. Background: Precedents in Africa and Elsewhere**

The broad lessons from international experience are clear. Participation in global markets is a necessary condition for sustainable economic development and poverty reduction. The extent and type of participation of any country is largely the result of its own policy choices. Countries that have

pursued liberal and relatively open trade policy regimes have performed much better than those that have not. No country that has closed itself from world markets has achieved rapid economic growth.<sup>1</sup>

The key to openness in trade is the minimization of distortions and restrictions to imports and exports. Successful trade and growth experiences in Asia and elsewhere have often been characterized as ‘export-led growth.’ An equally accurate and more informative description would be ‘import-led growth.’ Freedom of access to imports – at the lowest possible cost and with a minimum of logistical and bureaucratic barriers – is the *sine qua non* of competitiveness and growth of exports of manufactured goods.

The comparative advantage of poorer countries in labor-intensive exports is the guarantee that outward oriented development is job- and equity-enhancing and that it is a powerful instrument of poverty reduction. International experience has shown time and again that trade is one of the most effective and reliable tools available for achieving sustainable growth and poverty reduction in developing countries.

Within SADC, Mauritius provides an excellent case study of the economic achievements that are possible through outward-oriented trade policies.

At the time of its independence Mauritius was widely regarded as facing among the bleakest economic prospects of all countries in the world. Some of Britain’s best economists, including a future Nobel laureate, were appointed to study these prospects and to propose solutions. The result was some excellent analysis that confirmed the serious difficulties facing the country as it launched itself into independent economic development.<sup>2</sup>

Mauritius was among the poorest countries in the world. The population was too high to be supported by the limited land and natural resources available on the island. Any wage sufficient to induce landowners to hire the available labor force would be too low to support even a bare subsistence standard of living. Under existing economic structures, the only hope was in the emergence of technologies that would permit large increases in sugar yields, or changes in world markets that would give rise to significant increases in world sugar prices. Neither of these events was very likely. Mauritius, therefore, was stuck in a classic Malthusian trap, condemned to grinding poverty, almost inevitable ethnic strife and resulting political and economic instability. It appeared to be a hopeless case.

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<sup>1</sup> The UK Government White Paper on international development (Secretary of State 2000) provides a particularly useful and balanced view of the role of trade in development. While recognizing the importance of a wide variety of governance, and human, physical and natural capital investment policies, it emphasizes the central role of trade policies in harnessing the forces of globalization for the benefit of the poor.

“Everywhere it is clear that openness is a necessary – though not sufficient – condition for national prosperity. No developed country is closed. The initially poor countries that have been most successful in catching up in recent decades – the newly industrialising east Asian countries and China – seized the opportunity offered by more open world markets to build strong export sectors and to attract inward investment.” (Secretary of State 2000, p.17)

A World Bank report (World Bank 2001a) reexamined the potential role of trade policy reforms in the run up to the WTO Doha meetings. The principal conclusion is that further removal of barriers to world trade could raise global income by US\$2,800 billion by 2015. For poor countries alone, the effect would be an increase in incomes of US\$1,500 billion (over half the increase in world income) and the lifting of 320 million people out of poverty. Much of the gains to poor countries could be obtained by unilateral trade liberalization by their own governments.

For an overview of the role of sovereign trade policies in the context of the WTO agenda, see also Flatters 2001b.

<sup>2</sup> For an elegant and highly readable overview of the findings, see Meade 1964.

Thirty years later Mauritius would be unrecognizable to those who participated in the British-commissioned study. Per capita income (US\$, PPP adjusted) in 1998 was \$8,312, compared with \$1,607 for Sub-Saharan Africa and \$3,270 for all developing countries (UNDP 2001). Per capita income growth was 4 percent, compared with -0.3 percent in sub-Saharan Africa and 1.4 percent in all developing countries (World Bank 2001). Other human development indicators show similar differences between Mauritius and sub-Saharan Africa or all other developing countries. Adult literacy was in 1998 was 83.8 percent in Mauritius, compared with 58.5 percent in all of sub-Saharan Africa and 72.3 percent in all developing countries; life expectancy at birth in 1998 was 71.6 years in Mauritius, compared with 48.9 years in sub-Saharan Africa and 64.7 years in all developing countries (UNDP 2001).

Central to the achievement of the Mauritius ‘miracle’ have been:

- recognition of special opportunities available in world markets, and
- trade promoting policy reforms – facilitation of the import of raw materials and the export of processed products, with the absolute minimum of regulation and conditions attached.

Outward oriented investors in Mauritius were permitted to import whatever they wished, from whatever source they wished, to engage in any processing of these materials that they were able to do economically in Mauritius, and to export the resulting products to any market in the world.

One of the major achievements of this ‘miracle’ was enormous new job creation in outward oriented manufacturing. As a result, Mauritius is now facing labor shortages rather than surpluses; wages and skill levels have risen to the point that Mauritius is rapidly losing its comparative advantage in low-skill labor intensive manufacturing. Mauritius is now graduating from producing low skill manufactures to exporting more skill-intensive products. It has become a regional growth engine – a hub for coordination and logistical support of production and exports of a wide range of services and manufactures, many of which are related to the textile and garment value chain.

Mauritius is an African example of the gains from participation in global markets. Central to its success has been a policy environment which has made trade as easy as possible and has permitted investors, domestic and foreign, to engage in activities that could be done best in Mauritius.

### **3. What Does AGOA Offer?**

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

#### **4. What Does SADC Offer?**

SADC offers eventual regional free trade among all SADC Member States, subject to rules of origin that specify the minimum regional content required for any good to qualify for regional preferences.

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. 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.

#### **5. Origins: Domestic Policies and the SADC Regime**

The rules of origin and tariff liberalization schedules in SADC did not emerge in a vacuum. They 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 that have been noted already, 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, 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.

##### **5.1 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>3</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.

## 5.2 Mauritius

The textile and garment industry in Mauritius is predominantly export-oriented. As indicated earlier, a large part of her economic success over the past three decades can be attributed to the policy 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.<sup>4</sup>

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

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<sup>3</sup> Stern and Netshitomboni 2001 document the small share of current South African garment exports that currently qualify under the AGOA rules of origin.

<sup>4</sup> See Box 7 “Refrigerators: Rules of Origin and Benefits of Regional Trade Liberalization” in Flatters 2001b for an illustrative case.

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.

### 5.3 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 2 in the following section). 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.

### 5.4 Competing Visions of SADC

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.<sup>5</sup> The two visions and the alternate policy directions are well illustrated in the textile and garment sector.

- 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 in this sector has been distinctly inward-looking. *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.*

## 6. Assessment of Rules of Origin

Rules of origin in both AGOA and SADC are critical to the development prospects of the textile and clothing industries in SADC.

### 6.1 AGOA

AGOA's rules of origin are exogenous to SADC Member States. They have been determined by the US Congress and cannot be altered by any actions in SADC. They are the outcome of negotiations among conflicting US interests. On the one hand, garment buyers and American pro-Africa lobbies

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<sup>5</sup> See Flatters 2001a.

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.

As already indicated, the restrictive AGOA rules are a double-edged sword for Africa. On the one hand they impose a serious handicap on regional garment industries wishing to take advantage of AGOA-related market opportunities. On the other hand, they provide a captive market and hence unique development opportunity for upstream yarn and fabric producers.

Serious limitations in regional yarn and fabric production capacities have already been identified (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 1).

### **1. Demand for and Development of 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 2).

## **2. 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.

## **6.2 SADC**

The SADC rules of origin have been decided and can only be altered by agreement among the Member States. 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 3). 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.

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

The SADC TNF process has agreed on double transformation as the standard rule of origin to qualify for SADC tariff preferences. That is, in order for regionally produced garments to qualify for such preferences they must be made from regionally produced fabric. 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.<sup>6</sup>

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 4). 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.

#### 4. 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

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<sup>6</sup> See Box 8 "EU Rules of Origin: An Appropriate Standard for SADC?" in Flatters 2002 for a brief explanation of the folly of using EU rules of origin as a model for SADC in other sectors.

– 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.*

Another very important observation about the double transformation rule is that, even with cumulation, it does not provide any incentive to non-SACU fabric producers, unless, they also spin their own yarn (see Box 5). Fabric made from imported yarn would not qualify for SADC preferences. Thus, unless non-SACU fabric was spun from regional yarn, SACU garment makers wishing to use such non-SACU fabric would have to pay MFN import duties to obtain it. Even though the garments they would produce with such fabric would qualify for SADC preferences (by virtue of using SADC fabric), the fabric itself would not qualify. Thus the double transformation rule, even with cumulation, does not provide any preference for non-SACU fabric production.

### 5. The Limited Benefits of Cumulation

Double transformation requires that regionally produced garments be made from regionally manufactured fabric in order to qualify for SADC tariff preferences. Cumulation means that fabric and garment production need not occur in the same Member State – activities contributing to originating status can cumulate across different Member States.

If fabric and garment production occur in the same Member State, of course, there can be no difficulties or ambiguities; activities occurring in that State alone confer originating status and there need be no appeal to cumulation.

Suppose that fabric produced in one Member State is used to produce garments in a second Member State. Under the principle of cumulation it is clear that the resulting garments qualify for SADC tariff preferences. But what about the fabric from which the garments are produced? If the fabric is made from imported yarn, the fabric would not qualify for SADC tariff preferences, and would have to be imported into the garment producer’s market under MFN tariffs.

Even though the fabric is produced in the region and is being used in garments that will qualify for SADC preferences, the fabric will not qualify. With high tariffs on fabric, there would be a strong preference for domestically rather than regionally produced fabric. Despite the cumulation provision under the double transformation rule, the Trade Protocol encourages vertical integration only within individual Member State borders; it does not encourage *regional* integration of garment and textile industries. Regional integration is encouraged (or at least regional fabric is placed on a level playing field *vis à vis* domestic production in the

garment producing country) only when the garment producing country has zero MFN tariffs on fabric. But this is true regardless of the provisions of the Trade Protocol.

For weaving and knitting industries wanting to sell into SADC markets with high MFN tariffs on these products, such as South Africa, the double transformation rule will be of no assistance, even with the regional cumulation provision. Put alternatively, garment makers in countries such as South Africa, with high MFN tariffs on fabrics, will not benefit from increased regional fabric sourcing opportunities as a result of the SADC Trade Protocol.

The only fabric producers that will benefit from the double transformation rule will be those that have integrated spinning and weaving or knitting operations, or those that can source yarn within their own domestic market. This severely limits the number of SADC fabric producers that will have any chance of benefiting from the Trade Protocol.

Regional sourcing will be encouraged only if the double transformation rule is replaced by a rule requiring only single stage transformation.

*Contrary to the trade-promoting intent of the Trade Protocol and to the goal of using regional integration to improve competitiveness and take advantage of AGOA, SADC rules of the origin will prevent trade from taking place and impede the development of regional synergies of production in the textile and garment value-chain.*

## 7. Conclusions

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 Boxes 4 and 5).

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 (Box 5). 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 3).

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 4).

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.

*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.*

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