

Mid Term Review of the SADC Trade Protocol: Rules of Origin

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Table of Contents

Executive Summary	ii
1. Introduction	1
2. Rules of Origin and Competitiveness.....	2
3. Some Insights and Lessons from International Experience	3
3.1 The Costs of Restrictive Rules	3
3.2 Rules of Origin, Customs and Trade Facilitation	5
3.3 Improving Implementation of the Value-Added Rule.....	7
4. The Evolution of SADC Rules of Origin	8
4.1 Concerns about the Initial Rules of Origin	9
4.2 The Current Rules of Origin Regime	10
5. Current SADC Rules of Origin: Sectoral Issues	11
5.1 Agriculture and Processed Agricultural Products.....	11
5.1.1 Wheat Flour	12
5.1.2 Products of Wheat Flour	15
5.1.3 Coffee, Tea and Spices	16
5.1.4 Other Agricultural Processing.....	18
5.2 Selected Industrial and Manufactured Products	18
5.2.1 Chemical Products	18
5.2.2 Light Manufacturing	19
5.2.3 Textiles and Garments	21
5.2.4 The Motor Industry	23
6. Conclusions and Recommendations.....	25
References.....	27
Annex 1: Recommended Changes to List Rules.....	i

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Executive Summary

Rules of origin specify the conditions necessary for products to qualify for SADC tariff preferences. Thus they will be a key determinant of the long run impacts of the Trade Protocol. As currently structured and implemented, SADC's rules of origin may undermine the principal aims of the Protocol.

Prior to the recent global proliferation of bilateral and regional trade agreements, preferential rules of origin had not been a standard tool of trade policy. They have not benefited from international standards or agreed 'best practices' under the WTO. It is not surprising, therefore, that the negotiation of SADC rules of origin was lengthy and difficult. For most participants this was a learning process. In recognition of this, many rules were agreed only on the condition that the whole package be revisited at the time of the Mid Term Review.

The initial inclination of SADC trade negotiators was to adopt simple and unrestrictive rules of origin to participate and increase their competitiveness in the global economy. However, they decided to adopt a very different model based on the EU-Cotonou list rules of origin. As a result the Trade Protocol is now burdened with too many complex and highly restrictive product-specific rules of origin. Evidence and experience from the region and elsewhere now show that this is inappropriate for SADC-like countries; it is directly contrary to their long term development interests. SADC countries themselves are currently highlighting difficulties with very similar rules of origin in the Cotonou Agreement with the aim of revisiting them in their negotiations of Economic Partnership Agreements (EPAs) with the EU.

Many of the current SADC rules of origin will have negative implications for the Trade Protocol as a vehicle to promote the development of the region. Rather than facilitating development through trade, the Trade Protocol will replace transparent and declining tariff barriers in important sectors with complex and more restrictive input sourcing requirements that will diminish trade, increase transactions costs, reduce flexibility of producers and make the region a less attractive place to invest.

Restrictive rules of origin might be in the interests of particular producers that wish to avoid new competition in their domestic markets. By the same token, however, such rules will make it impossible for them to compete in other regional markets, make it difficult if not impossible to benefit from attractive sourcing opportunities in the region and elsewhere, and will deprive downstream users, both producers and final consumers of the benefits of preferential tariff reductions. Except for those benefiting from the use of rules of origin to restrict competition, less restrictive rules cannot hurt regional producers. By permitting increased flexibility and reducing transactions costs, they can only help them.

These conclusions are supported by case studies of the impacts of SADC rules of origin. Among the more interesting findings of these investigations is that many firms and sectors that were thought to need restrictive rules actually preferred less restrictive and less costly ones.

Most Member States face pressures from particular interests to delay or avoid the effects of regional trade liberalization. The Trade Protocol respects the sovereign rights of Member States to continue to protect a certain number of such sectors by declaring them sensitive and excluding them from the effects of preferential tariff reductions. The imposition of trade restricting rules of origin for this purpose, however, is inappropriate. It bypasses limits on the use of the sensitive sector provision and erects an artificial barrier to producers in other SADC Member States that would benefit from utilizing SADC trade preferences to trade among themselves. The use of WTO-approved safeguard measures is already provided for in the Trade Protocol to deal with cases of serious market disruption due to trade liberalization. Restrictive rules of origin should not be used for this purpose.

Other than smugglers and other illegal traders, of course, all stakeholders are in favor of effective enforcement of rules of origin, in order to prevent trade deflection that would circumvent legitimate import taxes imposed by Member States. But effective enforcement is very different from the imposition of rules that are difficult or impossible to satisfy or procedures that add unnecessary costs to participation in regional trade. The solution lies in enhancing the capacity of customs administrations towards effective enforcement of customs procedures. A number of interventions are already in progress within the context of the SADC customs co-operation which should be further improved upon.

The rules of origin in the original version of the SADC Trade Protocol were not only simple and relatively unrestrictive; they were also virtually identical to COMESA's. Overlapping membership and the desire to promote the development of the region through increased integration among the members of the two groups provide a strong argument for harmonization of their rules of origin. The COMESA rules would be the recommended model for this purpose. The COMESA model is also important in allowing firms the flexibility to satisfy alternative rules of origin.

Complex rules of origin add to the burden of customs and compromise trade facilitation objectives. In addition, the costs to firms of complying with rules of origin, in terms of maintaining systems that accurately account for imported inputs, will tend to rise with the complexity of the rules. The administrative costs of proving compliance with a tariff shift rule are likely to be lowest. Such a rule might not always suffice to confer origin, however, and so offering alternative rules related to regional value added and/or local content would provide additional flexibility for legitimate regional producers.

SADC's stated goal is to evolve into a customs union by 2010 – i.e. to become a free trade area with a common structure of external tariffs. Regardless of whether and when this goal is achieved, there is no doubt that MFN tariff rates will continue to fall and differences among the Member States' rates will diminish. This will reduce and eventually eliminate the scope for trade deflection. Rules of origin will become less and less important, especially for firms and governments interested in raising their export competitiveness. To saddle SADC with unnecessarily restrictive and burdensome rules of origin in these circumstances would be a mistake.

The SADC Trade Protocol can be a powerful tool in assisting Member States to integrate and increase their competitiveness in the global economy and hence to achieve higher growth and poverty reduction. Some of the current rules of origin will be a serious impediment to the realization of this dream.

In considering revisions to the current rules, Member States should be guided by their effects on global competitiveness of regional producers. This will be best achieved through rules that offer flexibility in two important respects: in decisions about sourcing of raw materials and intermediate inputs and in the choice of rules that can be applied to do so. The same rule might have different effects on different producers. Choice between CTH, value added and regional content will minimize the possibilities of unintended discrimination through imposition of a particular rule.

Members should also take account of recent experience in the application of rules of origin in other settings. There is an emerging consensus in rich and poorer countries alike that the EU must make fundamental changes to reduce the restrictiveness of rules of origin in previous preferential trading arrangements in Africa and elsewhere. With the exception of a few sectors, recent US bilateral trade agreements with developing countries include rules of origin that are far less restrictive than those in SADC or the EU. The general requirement is one of 35 percent value added, which is much less restrictive than almost all of the rules in the SADC Trade Protocol, except where CTH has been adopted. SADC Member States involved in such agreements would find it hard to justify imposing more restrictive rules on other SADC Members than they enjoy in the US or they are requesting with the EU. And SADC business communities would be justifiably perplexed by facing stricter requirements in selling to their neighbors than to the US or EU.

Based on these considerations our recommended rules of origin for SADC would include 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 setting out minimum levels of economic activity in the region. Under the specific rules goods would qualify for SADC tariff preferences if they

- are wholly produced in the region, or
- undergo a single change of tariff heading, or
- contain a minimum of 35 percent regional value added, or
- include non-SADC imported materials worth no more than 65 percent of the ex-factory cost of the good.

The change of tariff heading rule would have to be relaxed further in cases where the main inputs are classified in the same tariff heading as the final product.

Even in the event of difficulties reaching agreement on such a fundamental change in approach to SADC rules of origin, numerous improvements are possible. A complete list of proposed changes is included in Annex 1 to this report.

Mid Term Review of the SADC Trade Protocol: Rules of Origin

1. Introduction

Rules of origin set out the conditions necessary for products to qualify for SADC tariff preferences. Thus they will be a key determinant of the long run impacts of the Trade Protocol. As currently structured and implemented, SADC's rules of origin may undermine the principal aims of the Protocol.

Prior to the relatively recent proliferation of bilateral and regional trade agreements, preferential rules of origin had not been a standard tool of trade policy. Nor have rules of origin benefited from international standards or agreed 'best practices' under the WTO or other international agreements. WTO discussions on rules of origin are being conducted by a Committee on Rules of Origin in the WTO and a technical Committee under the auspices of the World Customs Organization in Brussels aimed at a single set of rules of origin to be applied but only under non-preferential trading conditions. It is not surprising, therefore, that the negotiation of SADC rules of origin was lengthy and difficult. For many, if not most participants, this was a learning process. In recognition of this, many rules were agreed only under the provision that the whole package be revisited at the time of the Mid Term Review.

The timing of this comprehensive review is opportune for several reasons.

- At the beginning of the SADC Trade Protocol negotiations there was little international experience to guide in the development of the SADC regime. Since then, considerable knowledge has accumulated from international experience in the use of preferential rules of origin. This experience covers reciprocal and non-reciprocal preference regimes, as well as north-north, north-south and south-south regimes.
- As already mentioned, the Trade Protocol negotiations have been a learning process for all participants and stakeholders. Information has been accumulated as a result of formal studies conducted for SADC and individual Member States, academic investigations, and workshops and seminars conducted by NGOs, institutes and different stakeholder groups. As a result, most stakeholders are now much better informed about the purposes and effects of alternative rules of origin.
- 'Hands-on' experience is beginning to accumulate about the actual operation and effects of SADC rules of origin.

As a result of all this recent experience and new information, many perceptions about SADC rules of origin have changed. Rules that were once thought to be benign or even helpful are now seen to be potentially harmful. The role of rules of origin in promoting or impeding international competitiveness of domestic producers, in helping or hurting regional consumers, and in facilitating or impeding trade are much better understood than when the negotiations began.

In short, many lessons have been learned in a relatively short period, and a comprehensive review at this stage provides a timely opportunity to assess the implications and take advantage of this new knowledge and experience.

2. Rules of Origin and Competitiveness

The immediate purpose of preferential trade agreements (PTAs) is to promote and facilitate trade among participating countries. Without complete harmonization of members' external tariffs, however, there is a danger that intra-PTA free trade might be used to subvert the intent of import duties applied against third parties. Suppose one member has an external tariff on garments of 50 percent and another imposes a duty of only 10 percent. In such a case exports from a third country might be able to enter the high duty market at a duty of only 10 percent by first entering the low duty country and then being re-exported to the high duty one under the PTA preference regime. The technical term given to such tariff avoidance is *trade deflection*.

The purpose of rules of origin is to prevent trade deflection, to ensure that only goods produced in PTA members qualify for PTA preferences. Rules of origin specify the necessary conditions for goods to be authenticated as being produced in a qualifying member country.

All rules of origin, including those in SADC, include a general provision specifying that repackaging, relabelling, simple mixing and assembly and other 'screwdriver' operations are not sufficient for products to qualify as regionally produced for the purpose of obtaining tariff preferences. For greater specificity and certainty most rules go further by specifying certain minimal levels of activity as necessary for a good to qualify. Such rules are generally specified in terms of the percentage of regional value-added, maximum levels of import content, and/or the degree of transformation undergone, often in reference to the HS tariff categorization of inputs and outputs.

The details of the specific rules and especially the amounts of local processing or input use required are very important. **From a long term developmental perspective, to ensure the international competitiveness of PTA producers in the global economy, it is critical that rules of origin do not unnecessarily restrict the flexibility of regional producers in sourcing of inputs and raw materials.**

One of the most important features of the globalization of economic activity in recent decades has been the 'delocalization' or 'fragmentation' of global manufacturing. Enormous improvements in transportation, communication and logistics have made it possible for the manufacture of almost all goods to become truly internationalized.¹ A key to successful economic development in these circumstances has been to create conditions in which local producers can participate in any and all stages of the resulting international value chains. But effective participation in this process requires ease of import and export and maximum flexibility in sourcing of inputs and raw materials. This is especially true for poorer countries that have not developed the sophisticated and diversified production bases that are sometimes achieved at higher levels of development.²

Overly demanding or complex rules of origin are a serious impediment to development in such a world. They restrict firms in their global sourcing decisions and they erect costly administrative barriers to international trade. Inappropriate rules of origin can be a major barrier to a region's international competitiveness.

Prevention of trade deflection requires not only appropriately defined rules of origin, but also proper administration of these rules. The dangers of trade deflection are greatest in PTAs with wide variations in MFN tariff structures among its members. In such PTAs stakeholders often call for 'strong' rules of origin. Unfortunately this description is ambiguous and can lead to inappropriate

¹ See Arndt and Kierzkowski 2001 and Cheng and Kierzkowski 2001, for instance.

² Mauritius is a classic (SADC) example of a country that has utilized trade in this way to escape from what once appeared to be an iron grip of poverty. For an excellent description of the problems faced at independence see Meade 1964 and for a brief summary of what has been achieved through effective participation in the global economy see section 2.2.2 of Flatters and Kirk 2004.

policy interpretations. ‘Strong’ rules of origin need to be interpreted as rules that are easily and properly enforced, not rules that are unduly restrictive or costly to comply with. See Box 1.

1. ‘Strong’ versus ‘Weak’ Rules of Origin

In the absence of properly enforced rules of origin, large differences in MFN tariff rates within a PTA can lead to trade deflection. This is sometime referred to as the need for a ‘strong’ rules of origin regime. What it really means is that the relevant authorities have in place procedures that can be used to prevent illegal intra-PTA trade that involves false declarations of origin-qualifying activities or even smuggling of third country goods from low duty member to a high duty member.

Unfortunately a ‘strong’ rules of origin regime is often interpreted as one with highly restrictive rules which would be difficult, if not impossible, to meet by most regional producers, and/or enforcement procedures that are so difficult and costly that very few traders, legitimate or illegitimate, would ever bother to try to meet. Occasional smugglers might try to find ways to ‘beat’ the rules, but producers would seldom ever bother to try to invest in trade under rules that cannot be met by legitimate means.

A ‘strong’ customs regime is one that can effectively enforce customs laws at minimal cost to the government or to legitimate importers and exporters. One hundred percent inspections and the imposition of long and arbitrary delays are signs of strength only in the sense of the display of power of customs officials. But they are a sign of a weak customs administration, relative to one that can enforce customs laws with well designed risk assessment procedures and speedy processing of imports and exports.

Excessively restrictive rules of origin and costly administrative procedures to enforce them undermine the purposes of a preferential trade agreement. They are a sign of weakness, not strength.

3. Some Insights and Lessons from International Experience

3.1 The Costs of Restrictive Rules

Awareness of the importance of rules of origin in determining the trade impact of preferential agreements has increased as such agreements have become subject to increased scrutiny. EU rules of origin have been criticized for limiting the benefits of non-reciprocal preferences under the GSP and Cotonou agreements. For example, under the EU’s Everything But Arms Agreement (EBA) for the least developed countries (part of the GSP), which offers duty free access for all products, only about 50 per cent of the preferences available to non-ACP countries are actually utilized.³ Rules of origin lie at the heart of this under-utilisation of preferences since most of these countries specialize in the production of clothing products for which EU rules of origin are restrictive, requiring production from yarn. These rules of origin are a fundamental reason why EU preferences under both the GSP and the Lomé and then Cotonou agreements have done little to stimulate the clothing sector in Africa. One justification for such restrictive rules has been to encourage an integrated textiles/clothing sector in Africa. **However, in practice these rules have done nothing to stimulate an efficient textile sector and have seriously constrained the growth of the clothing sector in many, particularly small, African countries.**

These rules of origin have been brought into stark contrast by the recent performance of sub-Saharan countries under AGOA. AGOA offers African countries, for the first time, the opportunity to export clothing products to the US duty free. Three categories of products are defined in terms of the rules of origin.

- Products assembled from fabrics and yarns formed and cut in the United States.

³ See Brenton (2003). The non-ACP countries can only export under the EBA. ACP countries can choose to use the Cotonou agreement. In fact most exports from ACP countries enter the EU under Cotonou rather than the EBA- one reason may be that the cumulation provisions under Cotonou are more extensive.

- Products assembled from fabrics formed in one or more of the AGOA beneficiaries from U.S. or regional yarns, subject to quantitative limits.
- Products assembled in LDCs from any fabric or yarn. This provision, recently extended, expires at the end of September 2007.

The first rule is extremely restrictive. Clothing assembled from non-U.S. fabrics (categories 2 and 3 above) is subject to quantitative restrictions which are related to the overall level of US imports of clothing. Within this there is a sub-limit on imports under the special rule of origin which allows for global sourcing of fabrics (category 3 above). For the year October 2002 to end of September 2003 the overall quota was 36 percent filled. Within this the limit on products subject to liberal rules of origin was 62 percent utilized. Whilst the quota on products assembled from regional fabric was less than 10 percent filled. This reflects in large part the differences in the restrictiveness of the rules of origin.

It is important to note that access to preferences on clothing products is not automatic for AGOA beneficiaries. Countries must apply for these benefits and there are requirements regarding measures to prevent illegal transshipment including an effective visa system for clothing products. These requirements are unlikely to be a barrier to the granting of clothing preferences in many countries and technical assistance in meeting the requirements is available. What is important is that the US sought to deal with the issue of illegal transshipment through the visa system and cooperation between customs authorities, including regular monitoring of customs data. This contrasts to arguments that have been made elsewhere that strict rules of origin are necessary to deal with such illegal activities. As will be discussed below, this is a misinterpretation of the role of the rules of origin. **Illegal activity may take place whatever the nature of the rules of origin and procedures need to be put in place to identify and prevent such activity. The rules of origin should be set only with regard to legal activity and define the amount of processing that is required to assign country of origin to a product.**

AGOA has had a profound impact on the exports of a small group of sub-Saharan African countries, almost entirely as a result of the provisions regarding clothing.⁴ All of the countries that have been able to substantially increase exports of clothing to the US have been eligible for the liberal rule of origin and to source fabrics globally. Preferences for clothing products subject to the liberal rule of origin have been fully utilised. Mauritius and South Africa are the only two countries that are eligible for clothing preferences but which have not been granted liberal rules of origin. In 2002, 90 percent of exports from Mauritius to the U.S. were clothing products, yet only 41 percent of the available preferences for these products were taken up. Clothing only accounts for about 4 percent of South African exports to the U.S. although the absolute amount is similar to that exported by Mauritius. In 2002 only 47 percent of the available preferences for South African clothing products were actually utilized. The issue with the more restrictive rules of origin is not just the constraints that these rules impose on the sourcing of inputs, forcing producers to use higher cost fabrics and materials, but also the costs and difficulties in proving conformity with these rules compared to the more liberal rules where fabrics can be globally sourced.

It is in this context that the EU has initiated a fundamental review of its preferential rules of origin. The Green Paper issued by the Commission to promote discussion of reform accepts that “the Community’s efforts to attain its development objectives are sometimes hampered by the fact that the developing countries that are potential beneficiaries of the preferences are unable to take full advantage of them for a series of reasons, among them the difficulty of complying with some of the rules of origin.” The Commission further accepts that the beneficiaries “often lack the production facilities, investment opportunities or administrative organization needed to meet the conditions

⁴ Here it is interesting to look at Lesotho, which in 2002 exported \$321 million of goods to the US (entirely clothing, duty free under the liberal rule of origin) whilst exports to the EU were only 14 million euro. Lesotho has duty free access to the EU for clothing but there are the much more restrictive rules of origin.

imposed.... the complexity of some of the rules, the fact that some traders have difficulty understanding them and the cost of the relevant formalities.”

It is also illuminating that the Commission accepts that its rules of origin were designed in part to protect EU interests but that in a globalised world in which many industries have restructured and delocalised, policy has shifted toward a general drive to facilitate the access of EU exports to third markets and that the existing preferential rules of origin, which were drawn up in the 1970s are “not geared to such an approach” (p.7).

3.2 Rules of Origin, Customs and Trade Facilitation

Rules of origin, whilst an essential element of free trade agreements, add extra complexity to the trading system for traders, Customs and trade policy officials. For companies there is not only the issue of complying with the rules on sufficient processing but also the cost of obtaining the certificate of origin, including any delays that arise in obtaining the certificate. The costs of proving origin involve satisfying a number of administrative procedures so as to provide the documentation that is required and the costs of maintaining systems that accurately account for imported inputs from different sources to prove consistency with the rules. The ability to prove origin may well require the use of, what are for small companies in developing and transition economies sophisticated and expensive accounting procedures. Without such procedures it is difficult for companies to show precisely the geographical breakdown of the inputs that they have used.

The available studies suggest that the costs of providing the appropriate documentation to prove origin can be around 2-3 percent or more of the value of the export shipment for companies in developed countries. The costs of proving origin may be even higher, and possibly prohibitive, in countries where Customs mechanisms are poorly developed. Thus, even if producers can satisfy the rules of origin, in terms of meeting the technical requirements, they may not request preferential access because the costs of proving origin are high relative to the duty reduction that is available.

The costs of complying with the certification requirements of rules of origin will tend to vary across different agreements depending upon the precise requirements that are specified. With regard to the issuing and inspection of the preferential certificate of origin, EU agreements, Mercosur, AFTA, Japan-Singapore all mandate that certificates must be verified and endorsed by a recognized official body, such as Customs or the Ministry of Trade. In certain cases private entities can be involved provided that they are approved and monitored by the government. In contrast agreements involving the US provide for self-certification by the exporter. The authorities of the exporting country are not involved and are not responsible for the accuracy of the information provided in the certificates. In principal this should reduce the administrative burden of complying with the rules of origin. Further, under NAFTA a certificate of origin is valid for multiple shipments of identical goods within a 1-year period, whilst in most other agreements a separate certificate of origin is required for each shipment. EU agreements, however, do allow for exporters whom the authorities approve and who make regular shipments to make an invoice declaration of origin.

Under NAFTA both the importer and exporter are required to keep relevant records. Both exporter and importer must keep the certificate of origin and the supporting documentation for a period of five years. If Customs wish to make inquiries concerning a particular shipment or shipments under NAFTA they are directed to the exporter of the product. In cases where the exporter cannot substantiate a claim for preferential access then the importer becomes liable for the duty. In cases where fraud is suspected liability extends to both exporters and importers, whereas prior to NAFTA importers bore all financial and legal liability for compliance with Customs rules. Under EU agreements it is the importer who is legally liable for any penalties for tax evasion should it be subsequently found that a good was not eligible for preferential access. Under the EU's GSP the EU also holds the Government of the exporting country responsible for administrative cooperation, with suspension and removal of GSP preferences the ultimate sanction for inadequate cooperation.

SADC has agreed on the issuance of valid SADC Certificates of Origin by either public agencies such as the Ministries of Trade, Customs Authorities and in some cases private sector agencies such as Chambers of Commerce and Industries. Both approaches are being used by SADC countries. Problems are being reported with the verification of the Certificates of Origin. Currently, Member States are required to notify the SADC Secretariat of the names of the agencies authorized to issue certificates as well as a specimen signatures of officials. **This does not work well especially when specimen signatures change considerably for various reasons or no copies of such specimen signatures are available at some border posts, contributing to substantial costs to traders either through delays at border posts or through payment of MFN tariffs pending reimbursement which often takes longer.**

A recent survey of Customs Directorates by the WCO and the World Bank suggested the following key conclusions regarding the impact of rules of origin on Customs.

- *Rules of origin entail additional burdens on Customs.* Three quarters of those Customs officials who responded believe that clearance of preferential imports requires more manpower to deal with issues arising from the preferential rules of origin. One element of this is likely to be that in most trade agreements proof of origin is required for every single shipment. Based on information collected so far, limitations on the period of validity of certificates are the source of a similar problem in SADC. In general, the additional burden on Customs from preferential rules of origin will be greater the more complicated the rules of origin and the more manpower resources that are required to check conformity with those rules of origin.
- *Overlapping rules of origin from multiple PTAs cause problems.* Almost half of the respondents responded that in their experience overlapping rules of origin were a problem. Of respondents in Africa, two-thirds agreed that problems arose from the presence of overlapping rules of origin. This suggests that there would be gains from some coordination of rules of origin across regional trade agreements with common members. Further, it suggests that a movement towards simple and clear rules of origin in preferential trade agreements would help to minimize the problems caused by overlapping rules of origin. This is the same in SADC where countries belong to different rules of origin regimes (COMESA, SADC and various regional bilaterals) as well as other regimes such as the AGOA visa system and the Cotonou Agreement. According to available reports this is an additional burden on Customs.
- *The value-added criterion is particularly difficult to implement.* More than 75 percent of the respondents reported that, of the different methods of conferring origin, the value-added criterion was particularly difficult to implement. This is a striking result but one that is understandable given the heavy demands on data and calculations made by value-added rules. Value-added rules lack predictability since changes in factors exogenous to the firm, such as exchange rates, can lead to different determinations of origin. Operations that confer origin in one location may not do so in another because of differences in wage costs. An operation that confers origin today may not do so tomorrow if exchange rates change. **This suggests that trade could be facilitated by providing for alternative means of conferring origin, such as through change of tariff classification. In other words companies can satisfy either a value-added rule or another rule such as change of tariff heading.**

Thus, when designing trade agreements the participants should bear in mind the implications for Customs of the rules of origin and that if such agreements are to be effective in stimulating trade then issues of administrative capacity in Customs need to be borne in mind. Complicated systems of rules of origin increase the complexity of Customs procedures and the burden upon origin certifying institutions. In a period where increasing emphasis has been placed upon trade facilitation and the improvement of efficiency in Customs and other trade-related institutions, the difficulties that preferential rules of origin create for firms and the relevant authorities in developing countries is an important consideration.

In general, clear, straightforward, transparent, and predictable rules of origin that require little or no administrative discretion will add less of a burden to Customs than complex rules. In this regard, if the objective is to stimulate trade, the use of general rather than product specific rules appears to be most appropriate for preferential rules of origin. **Less complicated rules of origin encourage trade between regional partners by reducing the transactions costs of undertaking such trade relative to more complex and restrictive rules of origin.**

3.3 Improving Implementation of the Value-Added Rule

In addition to the problems caused by fluctuating exchange rates and changes in the value of inputs, the experience of traders suggests that the way the value-added rule is specified can have important implications. Different agreements specify the value-added rule in different ways. In EU rules of origin the basis for the value-added calculation is the share of non-originating materials in the *ex-works price* of the product – that is the price paid for the product as it leaves the manufacturer in whose undertaking the last working or processing is carried out. Any other costs incurred in putting the product on the market, such as shipping charges, must be deducted from the sales price. This greatly complicates the valuation process by requiring additional calculations and documentation of the costs of these other items. Further, there may be situations in which an ex-works price is not defined because there is no actual sale, for example, products shipped by contract manufacturers and goods sent to a sales agent for future sale.

2. Comparison of EU and US Approaches to Value-Added Rules of Origin: Light Bulbs

US:

Basis of calculation: Net cost (cost of manufacture)

Rule: Non-originating materials must not exceed 70% of net cost

Example: Net cost \$1 per bulb, cost of imported ballast \$0.69 per bulb

Non-originating materials less than 70% of net cost, product is originating and eligible for preferential access.

Rule is met at any sales price, at any discount and at any shipping cost

EU:

Basis of calculation: Ex-works price

Rule: Non-originating materials must not exceed 40% of ex-works price

Ex-works price = sales price – cost of shipping

Example: Cost of imported ballast \$0.69 per bulb

Case 1: Product shipped to market with good transport links

Sales price = \$2, shipping cost = \$0.2

Product is originating $(0.69/(2-0.2)) = 0.38$

Case 2: Product shipped to market with bad transport links

Shipping cost = \$0.4

At sales price of \$2 product is not originating $(0.69/(2-0.4)) = 0.43$

Unless product can be sold for \$2.125 in this market the product will not be originating and not eligible for preferential access.

Case 3: Product shipped to market with good transport links but with end of year volume discount to supermarket

Sales price = \$1.9, shipping cost = \$0.2

Product is not originating $(0.69/(1.9-0.2)) = 0.406$

Under the EU rule precise and real time calculation is required – satisfaction of the rule is affected by transport costs and discounts offered to buyers.

Source: Example based on Barsony 2004

In contrast in some of the agreements of the US, such as NAFTA, and the FTA with Chile, exporters and producers may choose between two valuation methodologies, one based on the transaction value, which is essentially the f.o.b. price of the product, and one based on the *net cost* of the good, the total cost minus sales promotion, marketing and after-sales service costs, royalties, shipping and packaging costs and non-allowable interest costs. Because the transaction value generally provides for a broader basis for the calculation of the content of non-originating materials the value-added requirement is usually higher than for net cost. For example, where the value-added requirement specifies a regional value-content of 60 per cent of the transaction value the requirement under the net-cost method is usually 50 per cent.

Box 2 above highlights some issues that traders have raised regarding the use of ex-works prices as the basis for value-added calculations. Where value-added rules are specified in the SADC rules of origin they are based on ex-works price. **Hence, it would be worthwhile to consider giving traders the option to satisfy value-added requirements in terms of both ex-works prices and net cost.**

4. The Evolution of SADC Rules of Origin

By international standards the SADC rules of origin are relatively complex and restrictive.⁵ They did not start out that way. In the initial Trade Protocol the rules were simple, quite unrestrictive and consistent with those in other developing country PTAs, including COMESA.⁶ Harmonizing the SADC and COMESA rules was seen as a way to minimize compliance and enforcement costs, reduce confusion, and avoid costly diversion of activities between COMESA and SADC to take advantage of differences in the rules.

The original SADC rules included both general conditions stipulating that simple packaging, assembly and labeling, for instance, are insufficient to confer origin (Rule 3 of Annex I to the Protocol), and specific rules setting out minimum levels of economic activity in the region. Under the specific rules goods would qualify for SADC tariff preferences if they

- underwent a single change of tariff heading, or
- 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.

Agricultural and primary products needed to be wholly produced or obtained in the region.

The original agreement began to unravel and a new direction taken when negotiators started to consider the need for exceptions for particular sectors.

⁵ See Estevadordeal and Suominen (2003).

⁶ In fact the COMESA rules were relaxed slightly to bring them into greater conformity with those originally agreed in SADC. This is ironic in light of the fact that the original SADC rules were never implemented and were replaced instead with much more complex and restrictive rules. The irony is compounded by the current pressure from some parties in COMESA to follow SADC once again and 'tighten' the COMESA rules.

4.1 Concerns about the Initial Rules of Origin

Lying behind the discussions of individual sectors were several types of concerns. Some of these were explicit and others implicit during the negotiation processes.

Among the most frequently expressed concerns was that *weak customs administration* in some Member States would make it possible for non-originating goods to circumvent protection in other Member State markets by claiming eligibility for SADC preferences. Cheap clothing or electronic goods from Asia, for instance, might enter one country, pay minimal import duties and then be re-exported to and avoid import duties in another Member State by being described as SADC goods.

Two things would be necessary for this to happen.

- The original importer of the goods would have to have lower import duties than those in the ultimate destination, because of low duty rates or because of evasion of import duties due to weak customs administration.
- Goods that did not meet even minimal originating requirements through any activity other than relabelling, repackaging, etc. would have to be incorrectly certified as having undergone whatever processing is required by the rules of origin. This could happen only as a result of lax administration of certificates of origin in the SADC transit country.

Weak customs administration is a fact of life in almost all developing countries and contributes to many development problems. Recognizing this, as well as the fact that it might undermine the Trade Protocol itself, improvement of customs procedures and administration is an important part of the SADC policy agenda. However, whether tightening rules of origin would help to deal with the concerns described here is a question that needs to be examined.

A second concern underlying many of the discussions of SADC rules of origin is whether and how they might be used *to encourage the use of intermediate inputs and raw materials produced in the region*. One view, often implicit and sometimes explicit, is that if inputs for any traded goods are produced in the region, the rules of origin should require that these regional inputs be used for the downstream products to qualify for SADC tariff preferences. Used in this way, rules of origin would play a role similar to incentives and performance requirements that are now generally forbidden under WTO rules. **From a SADC developmental perspective the question is whether this is an effective way to encourage production of certain goods and what might be the unintended costs in impairing the competitiveness of downstream industries and on consumers.**

A third concern arose from the fact that Member States have quite different structures of production and protection of intermediate inputs and raw materials. *Differences in the protection of these inputs could impede the competitiveness of producers of downstream products in certain Member States with regional free trade in these goods*. High levels of agricultural protection in one Member State, for instance, might hinder the competitiveness of its agricultural processing industries relative to those in Member States that can import agricultural goods freely from world markets. A rule of origin requiring the use of regional agricultural inputs, it is argued, would help to level the playing field.

However, such a rule of origin also would raise the costs of all producers wanting to compete in regional markets, tend to favor the producers of downstream goods in countries that have local supplies of the relevant inputs, prevent or at least strongly discourage preferential trade among Member States that do not have local suppliers of the inputs, and penalize SADC consumers that might otherwise gain from greater freedom of regional trade.

These are the kinds of side effects and questions that need to be considered in using rules of origin to compensate for cost-raising protection of input producers in certain Member States. Another question

is the extent to which protection of local input producers actually raised costs and benefited these producers, especially in the agricultural sector.

A final issue that colored the discussions of rules of origin, less directly than the others maybe, was the *asymmetry and complexity of the Member States' tariff phase down schedules*. The tariff phase-down schedules were complex. During the transition to complete free trade it was agreed that less developed Member States could phase down their tariff rates at a slower rate than richer members (South Africa/SACU).⁷ Less developed Members also agreed and were permitted to phase down preferential tariffs more quickly among themselves than with respect to SACU.⁸ The fact that the tariff phase-downs had been decided prior to agreement on rules of origin placed the burden of dealing with any *ex post* complaints of excessively rapid liberalization on other instruments, most importantly rules of origin.

South African producers in some key sectors were not convinced of the rationale or fairness of permitting non-SACU Member States to offer slower tariff phase-downs to South Africa than to other Members, while South Africa committed itself to 'fast-track' tariff phase-downs to all Members. Furthermore, this asymmetry led them to focus almost entirely on potential new competition in their own market rather than new opportunities in SADC markets, which would only come at a much later date. Together with the fear of trade deflection arising from weak customs administration in other Member States, this led them to think of employing restrictive rules of origin to keep out 'unfair competition' from other Member States. Restrictive rules of origin could be employed as compensation for the more rapid tariff phase-downs agreed by South Africa.

This has meant that a temporary 'problem' – asymmetry of tariff phase-downs – was dealt with by a permanent fixture – restrictive rules of origin – designed explicitly to discourage preferential trade in SADC. The mid term review, of course, provides an ideal opportunity to reexamine the rules of origin as the tariff asymmetries will begin to disappear with full implementation of tariff reductions by all Member States.

4.2 The Current Rules of Origin Regime

The consideration of exceptions to the initially-agreed rules led to a complex and lengthy process of negotiation of sector- and product-specific rules of origin based, implicitly and/or explicitly, on some or all of the general concerns described above. The process gradually led to rules of origin being thought of, not simply as a means to prevent trade deflection, but rather as instruments to serve the needs of particular interests in the Member States, as perceived and interpreted by the SADC trade negotiators.

Eventual agreement was reached on rules for almost all sectors and products. The only products for which a rule has not been agreed are wheat flour (HS chapter 11) and products of wheat flour (HS chapter 19). However, the regime in the amended Trade Protocol is very different than had been agreed originally. It is characterized by made-to-measure, sector-specific rules that vary widely across chapters, headings and subheadings, and in general are significantly more restrictive. The change of tariff heading requirement has been replaced in many cases by multiple transformation rules and/or detailed descriptions of required production processes.⁹ Value added requirements have been raised and often considerably, and permissible levels of import content have been similarly

⁷ SACU is the Southern Africa Customs Union and comprises Botswana, Lesotho, Namibia, South Africa and Swaziland.

⁸ This transitional asymmetry was even carried over into rules of origin in the textile sector.

⁹ The detailed processing requirements were sometimes necessary because of difficulties in applying the CTH rule – CTH at the 4 digit level would not have been sufficient to confer origin.

decreased.¹⁰ Unlike the original rules, most products now face only a single rule, with no choice of means for claiming originating status. The structure of the HS tariff classification system means that some chemical products do not qualify under the CTH rule. It is always possible to deal with such cases on an *ad hoc* basis, as was done in negotiating the rules initially. Another approach that would provide far greater certainty to investors and producers would be to supplement all CTH rules with an alternative local content or regional value added requirement.

The rules are now much more like those in the EU and in PTAs with rich, highly industrialized countries.¹¹ The greatest similarity is with respect to the rules in the EU-South Africa and EU-ACP trade agreements. This is no coincidence; the EU-South Africa rules were frequently invoked during the negotiations as a model for SADC. This was often done with insufficient discussion about their appropriateness, relative to other possible models, for SADC.

Recent international experience and research suggest that the originally agreed rules might, after all, be a much closer to an appropriate model for trade agreements among small, incompletely industrialized countries such as most of those in SADC, and among countries at different levels of development and of significantly different sizes, as is also true of SADC. Evidence accumulated in SADC itself during the negotiation process and since the implementation of the Trade Protocol points in a similar direction.

The next part of this report examines some of the evidence from SADC.

5. Current SADC Rules of Origin: Sectoral Issues

The initial stages of the Trade Protocol negotiations were conducted on the basis of very little information about the implications of alternative rules of origin in different sectors. Several studies and reports done for the SADC Secretariat highlighted some of the important economic issues involved in the choice of rules of origin. This new information base and interest in the issues grew considerably as a result of seminars and workshops conducted by the Secretariat as well as by research institutes, government departments, Chambers of Commerce and other interested parties in a number of Member States. There can be no question that there is now far more information and experience on rules of origin in SADC than was available during the negotiations.

5.1 Agriculture and Processed Agricultural Products

The SADC economies are still heavily dependent on agriculture and on other primary products, and so these sectors have been important to all participants in the negotiations. For primary agricultural products the general rule, common to many PTAs in all parts of the world, is that the goods must be wholly produced in a Member State in order to qualify for SADC preferences. Assuming that it can be properly enforced, this is certainly sufficient to prevent trade deflection in agricultural products.

In addition, however, there has been strong pressure to use rules of origin to encourage the use of local raw materials in downstream processing industries. There are two variations on this argument.

- Requiring the use of regional raw materials will protect and/or encourage development of local agriculture. Without such a requirement, processors, especially in Member States with low agricultural tariffs, will substitute international for regional raw materials. Restrictive rules of origin on processed products will increase demand for regional agricultural products.

¹⁰ The amended Trade Protocol had replaced the original one before the Protocol was actually implemented. Therefore the relatively simple and liberal rules in the original Protocol never were applied in regulating intra-SADC trade.

¹¹ Estevadeordal and Suominen 2003 refer to this as the PANEURO model.

- Restrictive rules of origin that require the use of regionally produced raw materials in processed products will encourage greater regional value added in agriculture. They will encourage further downstream processing rather than the export of unprocessed raw materials.

The initial proposals and in many cases the eventually agreed rules for processed agricultural goods were generally in the form of a requirement that some or all agricultural inputs in these goods be wholly obtained in the region. Many of these decisions were made without adequate input from consumer interests or from other stakeholders in the directly affected upstream and downstream sectors. As more information was obtained, serious questions began to arise about the wisdom of such rules, in terms of the objectives just described above and more importantly the real benefits to primary producers, processors and consumers. In some cases it became clear that decisions were being strongly influenced by the interests of certain narrow interests in some Member States. Certain downstream processing industries promoted the use of restrictive rules in the interest of primary producers when their real interest was in preventing new competition in processed products as a result of SADC trade liberalization.

The issues are best illustrated by examining a few particular cases.

5.1.1 Wheat Flour¹²

Rules of origin for wheat flour (HS chapter 1101) and its products in HS chapters 1901, 1904 and 1905 have not yet been agreed. The main differences among the proposed rules for flour hinge on the amount of local/regional wheat that is required. At one extreme is a proposal requiring that 70 percent of the wheat used (by weight) be sourced in the region. At the other extreme are rules that make no reference to the source of the wheat and just require that the flour be milled in the region. The simplest of the latter rules requires only a change of tariff heading. The main differences in the proposed rules for downstream flour products also related to requirements on the local wheat content of flour used.

These proposals are best understood against a background of large variations in production capacities and in the regulatory environments for these products in SADC Member States. Several members produce significant amounts of wheat, although none are consistently self-sufficient. Others produce almost no wheat at all. South Africa is by far the dominant producer, in terms of both total production and the proportion of domestic demand that can be met from local production. South Africa also accounts for over 90 percent of all SADC exports of wheat (TIPS 2004, Table 2).

Some Member States provide considerable protection to local wheat growers and others provide none. Similarly, there are large variations in the amount of protection given to downstream producers of flour and its products. In addition, there has been significant and rapid deregulation in these industries in some member states recently, especially South Africa.

Variations in production capacities and in protectionist legacies have led to corresponding differences in policy stances with regard to liberalization of intra-SADC trade in these products. Member states with large and protected wheat and wheat flour industries have resisted liberalization of intra-SADC trade. In particular, they have advocated restrictive rules of origin as a means of insulating their producers against competition from other Member States.

Even in Member States that have resisted liberalization, however, there are significant and growing interests whose focus extends beyond national markets. This is especially true in certain downstream industries. These producers compete in regional and world markets and have a strong interest in a more liberal trading environment. The conditions that permit them to compete in international

¹² The argument in this and the following section is developed in more detail in Erasmus and Flatters 2003. For a regional perspective see also Zunckel 2002.

markets – especially unrestricted access to key raw material inputs – would not apply if SADC markets were governed by high tariffs, stringent rules of origin and other restrictions.

As indicated already, most of the debate about rules of origin has centred on wheat. There is disagreement on a number of key questions. How much is wheat being protected under current arrangements and how might this change as a result of SADC free trade under different rules of origin? Can or should the Trade Protocol be used to promote expansion of wheat growing in SADC? What is the true wheat growing capacity in SADC? The discussion has also been influenced by the well known distortions in international wheat and flour markets arising from protection and subsidy policies in major producing countries.¹³

SADC is not self sufficient in wheat. Outside of South Africa and Zimbabwe (until recently), only modest volumes of wheat are produced within SADC. Indeed even South Africa and Zimbabwe have always needed to import wheat in order to meet the requirements of the flour millers. South Africa is SADC's dominant producer, accounting for about 80 percent of total SADC production.

There are also questions about downstream milling industries. In particular, what are the implications of wheat policies on the competitiveness of flour milling in different member states and how might this change as a result of SADC free trade under different rules of origin? How much protection do they currently receive and how would this be affected by SADC trade under different rules of origin? Less attention has been paid to the implications of these policies and of alternatives for SADC trade liberalization for consumers of flour and flour products in member states. The ultimate burden of protection of wheat and wheat flour falls on consumers of these products, especially bread.

Tanzania and South Africa are the only members to place significant import duties on wheat. Tanzania's MFN duty is 25 percent, while South Africa has a specific duty that is triggered by a world price less than its 'long term average.' Whenever this happens the specific duty is set at the difference between the actual and long term average wheat price.¹⁴ This duty has been below 10 percent for the past two years and has been zero since December 2003.

This wheat duty, arguably intended to protect local wheat growers provides South Africa's main justification for a restrictive rule of origin for flour. Without such a rule, it is argued, millers in other member states would be able to import 'cheap' wheat on world markets, undermine South African millers in their domestic market and ultimately deprive local wheat growers of their only source of demand.

However, no rule of origin requiring significant amounts of regionally sourced wheat could be met by non-SACU millers. Therefore a rule of origin allegedly designed to protect South African millers and grain growers would also prevent all preferential SADC trade among non-SACU members. Only SACU millers would ever be able to satisfy the South Africa-proposed rule.

Closer study of the South African/SACU grain markets has revealed another problem with this justification for a restrictive rule of origin. In recent years at least, the SACU wheat tariff has provided very little if any assistance to local grain growers. Regardless of whether the world price has triggered the imposition of an import duty on wheat, domestic wheat prices in South Africa have

¹³ While these policies might be unfair to SADC wheat producers, they also provide potential benefits to consumers and users of these products in SADC. Generally speaking, the effect of these policies on the world wheat price tends to be considerably overstated in many policy discussions. Regardless of their impacts, however, it needs to be recognized that these distortions in world markets are intolerable in principle in the context of a developing region and far beyond the control of SADC or its member states. For the purposes of policy decisions at the SADC level, they might best be treated as exogenous.

¹⁴ While the SACU wheat duty applies to all SACU members, all except South Africa provide a full rebate. The stated purpose of the rebate is to reduce the cost of flour, an important ingredient of many basic foodstuffs.

tended to be equal to or less than the import parity price before import duty.¹⁵ In some regional markets they have been closer to export parity than to import parity. This explains the preference of non-South African SACU millers to purchase local South African wheat even when they could use the rebate facility to buy imported wheat on a duty free basis.

The South African wheat tariff appears to do little to protect domestic wheat growers, and to do little harm to flour millers. The only negative impact on millers is its effect on the price of imported wheat, which comprises 20 to 30 percent of their needs.

What protection is given to the SADC milling industries? All member states except Malawi, and of late SACU, tax imports of wheat flour. Outside of SACU and Malawi these duties range from 15 to 40 percent. The SACU duty is more complex. Until the beginning of 2003 it comprised two elements, a specific duty equal to 150 percent of that on wheat, and an additional *ad valorem* duty that started at 40 percent several years ago, and has systematically been phased down to zero in 2003. This has meant that access to the South African flour market has been open duty free to MFN imports, including of course all SADC states, since December 2003. This position is expected to remain within the foreseeable future due to the level of international wheat prices.

The net protection given to milling industries depends on the effects of tariffs on both wheat and flour. Estimates made in 2002 showed that the Member States' MFN tariff structures gave substantial protection to millers in most SADC Member States.¹⁶ This position has changed dramatically in SACU since that time, where the effective rate of protection is currently zero. Millers in Malawi and Mauritius get zero effective protection and those in Tanzania get 25 percent. Effective protection to milling in all other member states ranges from 75 to 127 percent.

With a few exceptions, SADC milling industries enjoy considerable protection. Within each market, milling industries tend to be oligopolistic and face little threat from external competition. The opening up of preferential intra-SADC trade could increase competition, especially from millers in markets with low wheat tariffs. It is understandable that milling industries in protected markets would want to block such competition. A restrictive rule of origin, or failure to agree on any rule at all, would serve this purpose well. Slow tariff phase downs outside of SACU (among the slowest in all sectors) are having the same effect, as has the erection of non-tariff barriers against imports of wheat flour, the most notable of which was a ban on all wheat flour imports in Namibia.

Rules of origin have been so far and might continue to be a major impediment to preferential intra-SADC trade in wheat flour. South Africa has insisted on a rule of origin that can be satisfied only by its own millers as a means of protecting them from the alleged effects of the South African wheat tariff. These alleged effects appear to be largely illusory, and so the main impact of the suggested rule would be simply to protect South African millers from SADC competition. It has been shown, however, that competition within the SACU milling industry is intense. It has been argued that under comparable market conditions the South African flour milling industry faces greater competitive pressure from other participants within the South African market than from the regional industry.¹⁷ This has to some extent been borne out by the fact that virtually no regional flour has entered the South African market despite this market being fully open with zero duties on flour at the MFN level since December 2003.¹⁸ The current situation makes the need for SADC preferences moot as the MFN position reflects the most favourable solution possible. This experience could provide some impetus for SACU to reconsider its stance on the SADC rule of origin. It is also notable that under the SACU tariff offer to SADC, flour is duty free as from 2004 onward.

¹⁵ See Box 2 of Erasmus and Flatters 2003.

¹⁶ See Table 8, p.17 of Flatters 2002d.

¹⁷ See Zunckel 2002, page 17.

¹⁸ Suppliers from outside of the region, notably India, have aggressively entered the SACU market under these conditions.

Regardless of the validity of the claims about the effects of the South African wheat tariff, a rule of origin that could be satisfied only by South African millers and would prevent SADC trade among other Member States is less than satisfactory solution. Furthermore, a rule of origin requiring “x percent” regional wheat content would be unenforceable in practice unless millers kept physically separate inventories for regional and international wheat and physically separate milling runs for flour milled for SADC and for other markets. This is however possible and is a Customs requirement for SACU millers wishing to claim duty drawbacks, when applicable, in respect of the imported wheat content of flour exports.

Wheat milling is a substantive economic activity; it is certainly not a simple relabelling, repackaging or mixing operation. Simple change of tariff heading is more than sufficient to ensure that wheat flour is not subject to trade deflection in SADC. If a particular Member State does not wish to participate in preferential SADC trade under these conditions, the appropriate step would be to declare wheat flour a sensitive product and exclude its market (and its millers) from this trade. It would still be able to import and export flour in SADC, but not with SADC preferences.

5.1.2 Products of Wheat Flour

Unlike flour, products such as pasta and biscuits (chapter 19) are ‘two steps removed’ in the production chain from the original agricultural raw material – they are products of processed agricultural goods rather than of the raw materials themselves. Nevertheless, restrictive rules of origin based on requirements to use local raw materials (whenever they might be available) were seriously proposed, and a rule requiring the use of locally milled flour is the favored proposal at the moment. Once again it is argued that this will promote demand for local agricultural products, in raw and processed form.

Good quality European style pasta requires durum wheat, which is not produced in the climatic and soil conditions prevalent in SADC. Local wheat could be used and some of the deficiencies could be overcome through use of special additives and heat treatment. While this makes it technically possible to produce ‘European’ type pasta, it is of higher cost and lower quality. The resulting pasta is brittle, and tends to crumble in shipping and storage, before the consumer ever opens the package.¹⁹ Most local pasta producers use flour milled from imported wheat, regardless of import duties.²⁰ A notable exception to this story is the Pioneer Food Group pasta plant in the Western Cape wheat production region of South Africa. Pioneer has been able to develop a cost effective pasta production process for its specialized plant using surplus regional wheat. This product scored above imported Italian pasta in blind tasting consumer trials and is supplied to a major retail chain which distributes the pasta to its stores in several SADC countries.

Requiring the use of flour milled from local wheat in order for pasta to receive SADC preferences would make the Trade Protocol irrelevant in this 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.²¹ Such a restrictive rule of origin would preserve protected markets from the threat of competition from regional suppliers operating under the Trade Protocol. However, 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. The cost of preferential-trade-impeding measures such as these would be borne by consumers through restricted choice and/or higher prices. As was seen earlier, there would be no offsetting gains to farmers.

¹⁹ A recently completed pasta plant in Namibia employs a high temperature process that overcomes some of the technical problems related to brittleness of product using local wheat. Nevertheless many consumers there and elsewhere find the flavor and other properties unacceptable and are willing to pay much higher prices to obtain better tasting pasta made from durum flour.

²⁰ In the case of South African pasta exports, the effect of import duties on flour is largely offset by use of the government’s duty rebate facility for exporters.

²¹ See Box 4 of Erasmus and Flatters 2003.

The specific case of durum wheat flour for use in pasta has been recognized and pasta made from durum flour now must satisfy only a change of tariff heading requirement. But the logic has not yet been permitted to carry over to any other products of wheat flour, or in fact any other products in HS chapters 1901, 1902, 1904 and 1905. No rules of origin for such products have been agreed for these products, making it impossible to trade them under SADC preferences.

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 flour milled from wheat 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 or use of special processes that would make the products almost impossible to market in the target markets.

Requiring only that the flour be milled in the region, but not necessarily from regionally grown wheat (the equivalent of a two stage transformation requirement), would be much less restrictive. However, it would still deprive producers of downstream products of the flexibility of using imported flours. To import grains in small quantities and have them milled in the region would often be much more costly than simply importing the required flour products, especially for specialty products not required in large quantities. In all likelihood, serious exporters of products requiring such inputs would simply bypass the SADC market, or at least preferential access to it, under the double transformation requirement.

A simple change of tariff heading rule is all that is necessary for these products. This has already been agreed in the case of pasta made from durum wheat. Requiring that products be made with locally milled flour should only be considered as a compromise option failing agreement on a rule of origin. 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 larger investments and numbers of jobs that will arise from the development of internationally competitive producers in the SADC region.

5.1.3 Coffee, Tea and Spices

Member states in which there is significant primary production of coffee, tea or spices and which impose significant external tariffs on these products have generally advocated restrictive rules of origin (high regional content requirements) for their downstream products, and those that are not major producers of the raw materials are happier with less restrictive rules.

The principal argument for restrictive rules of origin in these sectors is to encourage regional economic activity by

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

The current agreed rules are:

- 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 these products suggests that insistence on highly restrictive rules of origin reflects a fundamental misunderstanding of their likely effects. In the case of spice mixes, many of the relevant spices are not even available in the region, at any cost. Therefore the proposed rules would not accomplish any of their intended goals, for primary producers or for processors, and they would have the unintended consequence of preventing any intra-SADC preferential trade. They would impede rather than encourage the development of downstream processing activities, at least for the SADC market.

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

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. Growers' participation 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 would simply replace one customer by another, with minimal impact on the sellers or the producers of the raw materials. A restrictive rule of origin for coffee, tea or spices is of little 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.

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; it would decrease the overall competitiveness of coffee, tea, and spice processors. However, it would prevent any new regional competition for existing producers arising from SADC tariff reductions.

All other things equal, producers would prefer to source locally – for reasons of transport costs, speedy and reliable communication with suppliers, etc. 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,²² 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. Even where local raw materials are available, a surge in global demand or a crop failure in one key SADC market (e.g. cloves in Tanzania) could force processors to go elsewhere. Products that had been eligible for SADC preferences would suddenly become ineligible. There is no need for rules of origin to impose such uncertainties on regional processing industries.

²² This is a popular herbal tea in South Africa and the region, made from the leaves of the “red bush.”

If other barriers to trade, such as high transport costs, inefficient Customs procedures, SPS requirements or arbitrary NTBs or TBTs make it too costly for processors to source in the region, these issues should be dealt with directly. Restrictive rules of origin are not the appropriate solution.

Elimination of regional content requirements for the items in HS chapter 9 would provide further opportunities to improve the international competitiveness of SADC producers of these products, increase regional competition for the benefit of consumers and would do no harm regional growers of the raw materials.

5.1.4 Other Agricultural Processing

A number of other processed agricultural products have similar rules of origin, requiring that all or some of the raw materials be wholly obtained in the region. These include products in HS chapters 15, 16, 18, 20, 21, 22 and 24. Further technical study would be required to determine whether these requirements impose a real burden on processing industries. It should be observed, however, that as in the cases discussed in the previous section,

- if they are a burden, they reduce processors' competitiveness and hurt consumers through higher prices, while providing little if any benefit to the primary producers, and
- if they are not a burden, they are not necessary.

Even if the rules are not normally a burden, changes in circumstances could make them so. The rule for HS chapter 22, beverages, spirits and vinegar, for instance, requires that all grapes or grape derivatives be wholly obtained in the region. South African grape growers surely gain very little by forcing juice processors to use their grapes in the event of a boom in global demand for South African wines or a poor crop that makes it difficult for them to supply their normal buyers. Processors, on the other hand, might suffer considerably by losing their access to SADC tariff preferences as a result of the combined impact of rules of origin and events beyond their control in markets for their raw materials.

Food processing is a real economic activity and its products should not be excluded from SADC preferences on the basis of where raw materials are sourced. For most processed agricultural products a CTH rule should suffice to confer origin. As an additional protection for both processors and growers, an alternative value added requirement might also be added to deal with cases in which CTH is not sufficient to confer origin.

5.2 Selected Industrial and Manufactured Products

5.2.1 Chemical Products

Chemical products in HS chapters 27 to 29 are currently governed by a rule requiring CTH at the 4 digit level. This appears at first glance to be quite liberal. However, more detailed examination of these products in the context of negotiation of the SACU-US FTA has revealed some problems. A number of products now produced in South Africa would not qualify since the product and the main inputs are both included in the same 4 digit HS heading. There is no question that these are genuine manufacturing processes and would never be construed as chemical 'screwdriver operations'.

Several solutions have been proposed. One is to provide an alternative value-added rule for products that do not meet the CTH rule. Products that fail to satisfy the 4 digit CTH rule would still have the opportunity to qualify under the alternative local content or value added rule. There would remain a question about the appropriate local content requirement.

The other solution would be to require CTH at the 6 digit level. Recent US bilaterals (e.g. Chile) follow this path, with an additional set of definitions of what constitute legitimate chemical processes and a list of processes that do not qualify – the chemical equivalent of ‘screwdriver operations.’

A proposed solution for SADC along these lines is now under preparation.

5.2.2 Light Manufacturing

Some of the most contentious issues on manufacturing rules of origin rules have arisen in the light manufacturing industries in HS chapters 84, 85 and 90. These include machinery, electrical and electronic goods and components, and various kinds of technical and medical equipment.

The initially proposed general rule for products in Chapters 84, 85 and 90 was that non-originating raw materials used 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. A compromise eventually was reached on a chapter rule for chapters 84, 85 and 90 requiring a maximum import content of 60 percent of the *ex-works* price.

While the switch from *ex-factory* cost to *ex-works* price was eventually agreed, it is worth noting that, from a practical point of view in enforcing rules of origin, *ex-factory* cost might actually have been better. Any value measure is subject to some uncertainties when market prices of inputs and outputs vary over time. Such uncertainties are multiplied when the prices are determined in international markets and quoted in multiple currencies.

In SADC, where the importance of several resource-based economies makes exchange rates quite volatile, these uncertainties can be a major problem. The same economic activity might satisfy the rules of origin at one set of exchange rates and not come close to satisfying them under the exchange rates prevailing some later time. This can be especially true when, as in SADC, goods might be sold in several different markets, and changing exchange rates can have a significant impact on prices when measured in any particular currency. Measuring values at *ex-factory* costs can help to reduce one major source of exchange rate uncertainty, giving greater comfort to both buyers and sellers in predicting whether sales and purchases will satisfy the rules of origin.

Regardless of the basis for determining values, however, the most important issues relate to the exceptions to the chapter rule.

After negotiations that went on until late 2002 it was finally agreed that eight four-digit HS chapter sub-headings would ‘benefit from’ a more restrictive 45 percent maximum import content.²³ However, agreement was made subject to reconsideration during the mid term review of the Trade Protocol.

Several justifications were provided for such strict rules. Most were 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 ‘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.

²³ There has not yet been an opportunity to examine trade data to determine the effects of this decision.

While the ‘protectionist argument’ for restrictive rules of origin had some superficial plausibility and gained some acceptance, especially in the early stages of the negotiations, subsequent analysis and information gathered through examination of the firms and sectors for which they were intended yielded a very different picture. The improvements in understanding related to both the likely economic impacts of restrictive rules and the economic circumstances and interests of the sectors for which they were proposed.

It was the closer investigation of the circumstances and interests of the affected sectors, especially in South Africa, that produced the most interesting and (initially) surprising results.

There are many types of industries and firms represented in these sectors.

Domestic incentive structures – 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 some 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. But the evidence internationally as well as from many examples in SADC is that local assembly activities focused on supplying protected domestic markets often account for negligible amounts of economic activity, technology transfer or employment.

At the same time, there are also significant and growing numbers of internationally competitive exporters 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 more active players in global markets. This has generated many new regional jobs – far more in general than can be created in uncompetitive import substitution activities.

The actual degree of local content achieved in existing regional industries varies considerably. Some have levels of local content that are less than those specified by the relevant chapter rules, and many achieve considerably higher levels. In general, it is unlikely that the *chapter* rules would 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.

The more restrictive special rules for particular subheadings would be much more of a problem. Many producers in affected sectors were canvassed in the conduct of this work. Almost all of them, even those who could normally satisfy the existing rules, expressed a preference for less restrictive requirements that would allow them greater flexibility in sourcing of raw materials. Two Member States have submitted lists of products in these sectors for which they have requested a rule that is less restrictive than the chapter rule. This is certainly the position of the vast majority of producers in the context of trade negotiations with the EU and/or the US. The general practice in recent US bilaterals in these sectors is to require 35 percent local content, of which almost half can be sourced in the US.

It seems evident 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.

5.2.3 Textiles and Garments²⁴

Textiles and garments are of particular interest in SADC. This is one of the few manufacturing sectors in which there is significant production in a number of member states. Differences in labor intensity and other determinants of comparative costs 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. The opportunities recently opened up through the Africa Growth and Opportunities Act (AGOA) together with the looming uncertainties arising from the end of the Agreement on Textiles and Clothing (ATC) make this a crucial time for remedying domestic and regional policy weaknesses that have hindered the region's international competitiveness.

The successes of Lesotho and other countries that benefit from a non-restrictive rule of origin under AGOA are an important lesson for SADC. Lesotho, a small, least developed and landlocked country has experienced export-led economic growth in recent years. Foreign direct investment (FDI) into export-oriented manufacturing, largely in the garment and textile industries, accounted for the bulk of these investments.

Most inputs to foreign-owned firms established in Lesotho come from east Asia, the cheapest and most efficient source. This has been made possible by the fact that Lesotho has benefited from a single-transformation rule of origin under AGOA. Due to the growing scale of garment production, however, there have been recent investments in upstream textile production as well. This is similar to what happened in Mauritius earlier. Garment production for exports to the US market has increased almost three-fold between 2000 and 2003. Over 30,000 jobs have been created, with the primary beneficiaries being the urban poor and women. This is in contrast to Lesotho's export performance to the EU where a double-transformation rule is required to qualify for preferential market access.

As currently agreed, the movement to SADC free trade in textiles and garments will be slow and there are 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).²⁵

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 four poorest member states, Malawi, Mozambique, Tanzania and Zambia (known as the MMTZ countries), but only until July 2006, and subject to small quotas. It was agreed early on that this derogation and its phase-out would be reassessed as part of the mid term review of the Trade Protocol.

The current SADC rules of origin 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 certain of the key interests in the domestic textile and garment industries in the Member States. The rules of origin rely heavily on the model of the EU-South Africa free trade agreement, which is similar in turn to the EU Cotonou agreement. In the run up to the new EPA negotiations these rules are now under attack as being far too restrictive.

²⁴ This section draws on Flatters 2002a.

²⁵ 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.

The stated rationale for the double transformation rule was that it would encourage regional sourcing and deeper integration of the regional textile and garment industries. An examination of the regional industry, however, reveals very little such integration at the moment, especially for import substitution oriented producers. The scale of the local and regional markets alone is simply too small to make such integration economic.

Even in South Africa, the largest and most sophisticated market, the vast majority of garment producers use imported fabric. When asked how it would respond to a requirement that its garments be made from domestic or regional fabric (i.e. to meet the SADC rules of origin), the owner of one of South Africa's most successful garment producers replied: "We could not compete; we would shut our doors tomorrow."²⁶ 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.²⁷ 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 and the small scale of the domestic markets in most of SADC.

Enshrining in the Trade Protocol rules of origin that cannot be met even by South African garment producers arose in part from the structure of MFN tariff protection of this industry in SACU.²⁸ South African garment makers that sell in the domestic market and hence do not benefit from duty rebates or additional export incentives 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.

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. Similarly, South African garment makers do not wish to compete with those in other Member States that do not suffer the cost-raising effects of high tariffs on fabric. A double transformation rule of origin 'solves' this problem by ensuring that such competition will never occur. The rule 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 the handicap of high domestic textile duties. The same explanation applies one stage further back in the production chain.

Since most South African producers cannot satisfy this rule of origin, it is highly unlikely that it could be met by non-SACU producers. The double transformation rule 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 SADC textile and garment producers.

The real challenge facing the SADC textile and garment industries is the expiry of the Agreement on Textiles and Clothing (ATC) at the end of 2004. The post ATC world will be one of ruthless competition, with competitive producers minimizing costs by sourcing fabrics and other raw materials from the most economic al sources. Market shares will no longer be determined by quota arrangements in rich country markets. They will depend solely on suppliers' abilities to compete on the basis of cost, quality and timeliness of delivery. Producers that are burdened by cumbersome Customs procedures and administrative requirements of dealing with rules of origin requirements in regional markets will find it more difficult to compete.

²⁶ Source: case study interviews.

²⁷ See Box 3 of Flatters 2002a.

²⁸ See Box 4 of Flatters 2002a.

The complementarities among SADC Member States in this sector will be best exploited, not by forcing producers to source in the region, but by minimizing the costs of doing so. To burden SADC producers with a regime that requires them to source fabrics within the region in order to benefit from SADC preferences will do nothing to prepare them to compete in the new global environment or even in the region as MFN rates continue to fall.

Limitations in regional yarn and fabric production capacities have 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). The same is undoubtedly true in the EU. In trying to persuade the EU or the US to adopt and/or continue more liberal rules of origin under AGOA or the new EPAs, it will not help for SADC to impose a restrictive rule for trade among its own Member States.²⁹

For export-oriented garment and textile production, any SADC rules of origin are:

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

The stringent rules of origin and back-loaded tariff reduction schedules that are currently agreed for textiles and garments will be especially unhelpful to SADC as a means of taking advantage of US or EU preferences or adjusting to the challenges that will soon arise with the end of the ATC.

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.³⁰ 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. They impede rather than promote the increased competitiveness that will be necessary to survive in the post-ATC world in 2005 and beyond.

The main effect of the current rules of origin will be to ensure that SADC producers face no new regional competition as a result of the Trade Protocol. It is understandable for, say, South African garment makers to fear such competition *vis à vis* producers in Member States that do not suffer from the cost-raising effects of protection of yarn and textile producers. However, to solve this problem with rules of origin that prevent all preferential trade from taking place will mean that SADC garment consumers will see little if any benefit from SADC free trade. At the same time, the cost-raising effect of these rules will deprive SADC workers of the benefits of jobs arising from increased global competitiveness in this sector.

Recommendation: The rule of origin for textiles and garments should be changed to CTH and all quota restrictions on SADC preferential trade should be removed. This would make the MMTZ derogation redundant.

5.2.4 The Motor Industry³¹

The SADC motor industry, both vehicles and components, is dominated in terms of market size, and volume, value and diversity of production by one country, South Africa. Several other Member States have small assembly and after-market components industries. There are a small number of OEM

²⁹ 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 the garment and textile sectors (Table 1). The derogation of the yarn-forward rule for least developed countries under AGOA was recently extended until September 2007.

³⁰ See Box 5 of Flatters 2002a.

³¹ This section draws on the analysis in Flatters 2004 and Black and Muradzikwa 2002.

components makers outside of South Africa, but mainly within SACU. In all countries, including South Africa, the largest share of employment is in distribution, sales and after market service.

South Africa's industry has been driven in recent years by the Motor Industry Development Program (MIDP) that provides substantial subsidies to investment and production of vehicles and OEM components for export.³² The SADC Trade Protocol does not yet contain provisions dealing with preferential tariff treatment of goods produced with the assistance of export subsidies, and so eligibility for SADC tariff preferences depends only on the rules of origin in this sector.

SADC's currently agreed chapter rule for motor vehicles and components (HS 87) requires that the value of imported inputs not exceed 60 percent of the *ex works* price of the product. But most products of interest have more restrictive list rules, in the form of specific processing requirements and/or higher local content rules.

For most chassis or vehicles there is a processing requirement that "the engine, transmission, axles, radiators, suspension components, steering mechanisms, braking or electrical equipment or instrumentation must be fitted to the floor panels or chassis frame of the vehicle." And for most vehicles it is required that "the manufacture or assembly of the vehicle entails that the floor panels, body sides and roof panels must be attached to each other." These are meant to disqualify vehicles or chassis that result from simple assembly of completely knocked down (CKD) or semi knocked down (SKD) kits.

Production of vehicles from CKD or SKD kits is a notoriously high cost activity and could never compete with international scale vehicle production plants. The only way they can survive in any market is through high levels of import protection on vehicles and very low tariffs on imported kits.

The only condition under which CKD assembly could compete against full manufacturing production in another market would be if the target market was protected through high and escalating protection of both components and CBUs and the kit products were able to circumvent the high CBU tariffs. This is what threatened to happen in South Africa several years ago when an automobile assembly operation was set up in Botswana under protection of the high external SACU tariff on vehicles and with the benefit of duty-free import of kits. The very high tariffs on components in South Africa at that time, together with Botswana's duty-free access to the South African market under SACU, appeared to make it possible to overcome the competitive disadvantage of the high cost Botswana assembly operation. Significant financial subsidies to the company in Botswana also contributed.

But SACU tariffs are now much lower and are falling, and the general duty rebate on inputs under MIDP makes the burden of protection of inputs much lower still. In practice, South African vehicle producers operate in a duty-free environment for their component inputs. With producers no longer burdened by high input tariffs, the potential threat from another CKD kit venture is very difficult to imagine. The only way this could happen again would be with the assistance of large investment and/or export incentives as well. If this ever should happen, it should be handled through disciplines on subsidies, not through a restrictive rule of origin.

In addition to these process requirements, the regional content levels stipulated for many products are more restrictive than the chapter rule. For particular types of vehicles the maximum import content is set at 55 percent, and for vehicle components, the maximum import share is 40 or 50 percent, depending on the type of component.

These rules are quite restrictive and are now recognized as such by South African producers. The SADC rules are also much more restrictive than those in other preferential trading arrangements in which SADC Member States participate.

³² See Flatters 2002c and 2003.

The AGOA rules of origin on motor vehicles, under which South Africa is currently exporting duty-free to the US market, require local value added (cost of materials from AGOA-eligible countries plus direct costs of processing in AGOA-eligible countries) of at least 35 percent of the fob value; the import content may not exceed 65 percent. Up to 15 percent of the 35 percent local value can comprise US-made inputs (TISA December 2003). This means that only 20 percent of value of vehicles or components exported from South Africa needs to be sourced in the region in order to meet AGOA's rule of origin requirements.

Without a significant relaxation of the SADC rules of origin, there will be very little preferential trade in this sector, even when tariff rates are finally phased down. It is difficult to understand why any Member State would insist on rules that are any more restrictive than available under AGOA, especially when the benefits of such a rule are so apparent to producers in the South African motor industry.

South African producers are exporting to world markets. They have little to fear from competition by small-scale producers in other Member States. There is some evidence that they might even benefit from farming out labor-intensive production to such neighbors. When tariffs are eventually phased down in this sector, South African producers would certainly gain from preferential access to these markets. The currently agreed rules of origin will make it difficult, if not impossible, to realize any of these potential impacts of the SADC Trade Protocol.

Representatives of the National Association of Automobile Manufacturers of South Africa (NAAMSA) have indicated that they are taking this issue under consideration and will be making their own recommendations for relaxation of the SADC rules in due course. Other Member States, whose motor industries are much less developed than South Africa's, should assess these recommendations to determine whether they will afford them any opportunity to participate in the regional motor industry. **There is no need for the specific processing requirements that are now in the SADC list rules for this chapter. And any local content requirements that are more demanding than under AGOA (20 percent regional content) would be very difficult to justify.**

6. Conclusions and Recommendations

The Trade Protocol is now burdened with complex and highly restrictive product-specific rules of origin. Evidence and experience from the region and elsewhere now show that this is inappropriate for SADC-like countries; it is directly contrary to their long term development interests. SADC countries themselves are currently highlighting difficulties with the same rules of origin in the Cotonou Agreement with the aim of revisiting them in their negotiations of Economic Partnership Agreements (EPAs) with the EU.

The current SADC rules of origin regime may undermine the Trade Protocol as a vehicle for promoting the development of the region. Rather than facilitating development through trade, the Trade Protocol will replace transparent and declining tariff barriers with complex and more restrictive input sourcing requirements that will diminish trade, increase transactions costs, reduce flexibility of producers and make the region a less attractive place to invest.

Restrictive rules of origin might be in the interests of particular regional producers that wish to avoid new competition in their domestic markets. By the same token, however, such rules will make it impossible for them to compete in other regional markets, make it difficult if not impossible to benefit from attractive sourcing opportunities in the region and elsewhere, and will deprive downstream users, both producers and final consumers of the benefits of preferential tariff reductions. Except for those benefiting from the use of rules of origin to restrict competition, less restrictive rules cannot hurt regional producers. By permitting increased flexibility and reducing transactions costs, they can only help them.

These conclusions are supported by case studies of the impacts of SADC rules of origin. Among the more interesting findings was that many firms and sectors were thought to need restrictive rules actually preferred less restrictive and less costly ones.

SADC's stated goal is to evolve into a customs union by 2010 – i.e. to become a free trade area with a common structure of external tariffs. Regardless of whether and when this goal is achieved, there is no doubt that MFN tariff rates will continue to fall and differences among the Member States' rates will diminish even further. This will reduce and eventually eliminate the scope and incentive for trade deflection. In these circumstances rules of origin will become less and less important, especially for firms and governments interested in raising their export competitiveness. To saddle SADC with unnecessarily restrictive and burdensome rules of origin in these circumstances would be even more of a mistake.

The SADC Trade Protocol can be a powerful tool in assisting Member States to integrate and increase their competitiveness in the global economy. The current more restrictive rules of origin are a serious impediment to the realization of this dream.

Based on these considerations, our recommended rules of origin for SADC would include 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 setting out minimum levels of economic activity in the region. Under the specific rules goods would qualify for SADC tariff preferences if they

- are wholly produced in the region, or
- undergo a single change of tariff heading, or
- contain a minimum of 35 percent regional value added, or
- include non-SADC imported materials worth no more than 65 percent of the ex-factory cost of the good.

The change of tariff heading rule would have to be relaxed further in cases where the main inputs are classified in the same tariff heading as the final product.

In the event of failure to agree on this recommendation, we propose the specific changes at the chapter or tariff heading level in the current List Rules as outlined in Annex 1.

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Annex 1: Recommended Changes to List Rules

LIST OF CONDITIONS REGARDING WORKING OR PROCESSING REQUIRED TO BE CARRIED OUT ON NON-ORIGINATING MATERIALS IN ORDER THAT THE PRODUCT MANUFACTURED CAN OBTAIN ORIGINATING STATUS

(Note: Current rules appear in column 3 in **[Bold]**)

HS HEADING No.	DESCRIPTION OF PRODUCTS	WORKING OR PROCESSING CARRIED OUT ON NON-ORIGINATING MATERIALS THAT CONFERS ORIGINATING STATUS
(1)	(2)	(3)
ex Chapter 09	Coffee, tea, maté and spices; except for:	Manufacture in which the weight of the materials used does not exceed 65% [40%] of the weight of the product
ex 0910	Curry and mixtures of spices	Manufacture from materials of any heading [and cloves used must be wholly produced]
ex Chapter 11	Products of the milling industry; malt; starches; inulin; wheat gluten; except for:	[Manufacture in which all the cereals, edible vegetables, roots and tubers of headings Nos. 0708 and 0714 or fruit used must be wholly produced??]
ex 1101	- Wheat flour, Durum wheat flour	Manufacture in which all the materials used are classified within a heading other than that of the product [No rule for wheat flour]
ex 1106	Flour, meal and powder of the dried, shelled leguminous vegetables of heading No. 0713	[Manufacture in which all the materials of heading No. 0708 used must be wholly produced]
Chapter 15	Animal or vegetable fats and oils and their cleavage products; prepared edible fats; animal or vegetable waxes;	Manufacture in which all the materials used are classified within a heading other than that of the product [Wholly produced requirement for some inputs of headings 1501, 1502, 1504, 1506, 1516 and 1517]
1901 to 1905	Malt extract; food preparations of flour, groats, meal starch or malt extract, not containing cocoa or containing less than 40% by weight of cocoa calculated on a totally defatted basis, not elsewhere specified or included; food preparations of goods of heading Nos. 0401 to 0404, not containing cocoa or containing less than 5% by weight of cocoa calculated on a totally defatted basis, not elsewhere specified or included Pasta etc. Tapioca and substitutes therefor prepared from starch, in the form of flakes, grains, pearls, siftings or in similar forms Prepared foods obtained by the swelling or roasting of cereals or cereal products (for example, corn flakes); cereals (excluding maize corn), in grain form or in the form of flakes or other worked grains (except flour, groats and meal), pre-cooked, or otherwise prepared, not elsewhere specified or included Bread, pastry, cakes, biscuits and other bakers' wares, whether or not containing cocoa; communion wafers, empty cachets of a kind suitable for pharmaceutical use, sealing wafers, rice paper and similar products	Manufacture in which all the materials used are classified within a heading other than that of the product (and wheat flour must be originating) [No rule for 1901, 1902, 1904 and 1905, except for durum wheat and 1903 but condition for potato starch]
Chapter 20	Preparations of vegetables, fruit, nuts or other parts of plants	Manufacture in which all the materials used are classified within a heading other than that of the product [Manufacture in which all the materials of chapters 7 and 8 used must be wholly produced]

HS HEADING No.	DESCRIPTION OF PRODUCTS	WORKING OR PROCESSING CARRIED OUT ON NON-ORIGINATING MATERIALS THAT CONFERS ORIGINATING STATUS
(1)	(2)	(3)
Chapter 21	Miscellaneous edible preparations	Manufacture in which the value of the materials used does not exceed 65% of the ex-works cost of the product or manufacture in which all the materials used are classified within a heading other than that of the product <i>[Manufacture in which the value of the materials used does not exceed 60% of the ex-works price of the product]</i>
Chapter 22	Beverages, spirits and vinegar	Manufacture in which all the materials used are classified within a heading other than that of the product <i>[and all the grapes or any material derived from grapes used must be wholly produced]</i>
3901 to 3914	Plastics in primary forms	<i>[Manufacture in which:</i> - <i>all the materials used are classified within a heading other than that of the product; and</i> - <i>all the materials of heading No. 3915 used must be wholly produced</i>
3915	Waste, parings and scrap, of plastics	<i>Manufacture in which all the materials used must be wholly produced</i>
3916 to 3926	Semi-manufactures and articles of plastics	<i>Manufacture in which:</i> - <i>all the materials used are classified within a heading other than that of the product; or</i> - <i>the value of the materials of Chapter 39 used does (must) not exceed 55% of the ex-works price (65% of the ex-works cost) of the product; and</i> - <i>all the materials of heading No. 3915 used must be wholly produced]</i>
ex Chapter 44	Wood and articles of wood; wood charcoal; except for:	Manufacture in which the value of all the materials used does not exceed 65% of the ex-works cost <i>[40% of the ex-works price]</i> of the product
4403	Wood in the rough, whether or not stripped of bark or sapwood, or roughly squared	<i>[Manufacture in which all the materials of heading No. 4403 used must be wholly produced]</i>
Chapter 84	Nuclear reactors, boilers, machinery and mechanical appliances; parts thereof	Manufacture in which the value of all the materials used does not exceed 65% of the ex-works cost <i>[60% of the ex-works price]</i> of the product <i>[45% ex-works price for headings 8415, 8418, 8419, 8421, 8433, 8450, 8451, and 8481]</i>
Chapter 85	Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers, and parts and accessories of such articles, except for:	Manufacture in which the value of all the materials used does not exceed 65% of the ex-works cost <i>[60% of the ex-works price]</i> of the product
8544	Insulated (including enamelled or anodised) wire, cable (including co-axial cable) and other insulated electric conductors; optical fibre cables, made up of individually sheathed fibres, whether or not assembled with electric conductors or fitted with connectors	To be further reviewed <i>[... and the copper (metallic conductors) used must be wholly produced]</i> <i>[45% ex-works price for heading 8516; 55% ex-works price for headings 8501, 8503, 8504, 8509, 8512, 8517, 8532, 8535, 8536, 8537, 8538; description of manufacturing process for heading 8528]</i>
Chapter 87	Vehicles other than railway or tramway rolling-stock, and parts and accessories thereof; except for:	Manufacture in which the value of all the materials used does not exceed 65% of the ex-works cost <i>[60% of the ex-works price]</i> of the product <i>[Various percentage non-originating material limitations and specific assembly conditions on light and heavy vehicles of headings 8701, 8702, 8703, 8704, 8706 and 8707; 50% ex-works price for headings 8708, 8716.20, 8716.31; 40% ex-works price for heading 8716]</i>

HS HEADING No.	DESCRIPTION OF PRODUCTS	WORKING OR PROCESSING CARRIED OUT ON NON-ORIGINATING MATERIALS THAT CONFERS ORIGINATING STATUS
(1)	(2)	(3)
ex Chapter 90	Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments and apparatus; parts and accessories thereof	<p>Manufacture in which the value of the materials used does not exceed 65% of the ex-works cost [60% of the ex-works price] of the product</p> <p>[55% ex-works price for headings 9001.10, 9018.31, 9018.32 and 9032.10]</p>
ex Chapter 94	<p>Furniture; bedding, mattresses, mattress supports, cushions and similar stuffed furnishings; lamps and lighting fittings, not elsewhere specified or included; illuminated signs, illuminated name-plates and the like; prefabricated buildings; except for:</p> <p>9402 Medical, surgical, dental or veterinary furniture (for example, operating tables, examination tables, hospital beds with mechanical fittings, dentists' chairs); barbers' chairs and similar chairs, having rotating as well as both reclining and elevating movements; parts of the foregoing articles</p> <p>9403.10 Metal furniture of a kind used in offices</p> <p>9403.20 Other metal furniture</p>	<p>Manufacture in which the value of all the materials used does not exceed 65% of the ex-works cost [40% of the ex-works price] of the product</p> <p>Manufacture in which the value of all the materials used does not exceed 65% of the ex-works cost [price] of the product</p> <p>Manufacture in which the value of all the materials used does not exceed 65% of the ex-works cost [price] of the product</p> <p>Manufacture in which the value of all the materials used does not exceed 65% of the ex-works cost [price] of the product</p>