The SADC Trade Protocol:
Towards a Resolution of Outstanding Issues on Rules of Origin

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Summary

This report outlines outstanding issues on SADC rules of origin and provides some analysis and commentary aimed at clarifying the implications of alternate solutions. It draws attention to serious dangers in the use of restrictive rules as are being proposed for many sectors.

Rules of origin can serve two principal purposes. The *first* is to ensure that non-members do not benefit from market access privileges intended only for members. This is their *authentication function*. In the absence of some well-defined rule of origin, there is a danger that goods will enter the free trade area *via* a low tariff member and then pass duty free into the market of a higher tariff member. This is often referred to as 'tariff jumping' or 'trade deflection'.

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

The SADC Trade Protocol includes general conditions stipulating that simple packaging, assembly and labeling, for instance, are insufficient to confer originating status, as well as specific rules for all chapters of the HS tariff code. The specific rules define minimum levels of locally originating costs and/or certain specific types of local manufacturing or processing activity that are necessary to confer origin.

The *second* purpose of rules of origin is to provide encouragement for certain regional activities or to protect them from potential competition arising from the formation of the preferential trade agreement (PTA). This is the *protective effect* (intended or unintended) of rules of origin. This protectionist approach could be dangerous.

By depriving producers of access to raw materials or intermediate products from low cost international sources, strict rules of origin can raise the cost of producing a product for sale in the PTA. *Restrictive rules of origin thus shield existing producers from new competition and deprive consumers of the benefits of regional tariff reductions.*

The defensive variation of this theme – the use of rules of origin to force potential regional competitors to operate under the same policy-induced handicaps as those in a particular Member State is similarly harmful. *At best it will make SADC irrelevant for internationally competitive producers who source materials from the best international sources. At worst, it will induce other Member States to adopt high cost, internationally uncompetitive production methods, not for normal economic reasons, but simply to satisfy the rules of origin.*

Strict rules of origin can also induce regional producers to use regional inputs, thus assisting regional producers of such goods. Such an incentive is necessary only if their local/regional production costs are higher than international prices of the same goods. *Therefore, the burden of rules of origin designed to encourage regional production of raw materials will be borne in the form of higher costs by downstream user industries*.

The report outlines some of the principal issues arising in the sectors where agreement has not yet been reached. In addition, a number of case studies and examples illustrate the costs of excessively restrictive rules of origin in SADC.

The manufacturing sectors of SADC Member States are highly varied. There are import substitution industries that manufacture under significant external tariff protection. Domestic incentive structures have encouraged the development of high cost activities that are unable to compete internationally in terms of price or product quality. A major reason for lack of competitiveness is the small scale of production necessary to meet local and regional market demand. 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.

At the same time, there are many internationally competitive SADC exporters. There are exports to the region and also to global markets, including Europe and North America. Extra-regional exports are of much greater importance in most sectors.

A number of ‘new exports’ have developed as a result of increased openness and competitiveness following MFN-based trade liberalization. Previously inward-looking import substitution industries have become much more active players in global markets. This has generated many new jobs – far more in general than can be created in uncompetitive import substitution activities.

Some stakeholders also wish to burden rules of origin with other social and economic functions ranging from enforcement of industrial and consumer safety standards, to protection of the regional environment, and ensuring that foreign producers do not engage in anti-competitive dumping practices in the region. These objectives are better met through the use of specialized instruments and agencies. Rules of origin are ineffective and costly.

Experience internationally and in SADC itself shows that the development of internationally competitive industries requires flexibility in the sourcing of raw materials and intermediate inputs. An environment that encourages this flexibility will foster the investment necessary for the region’s long-term development and for the generation of badly needed employment opportunities for its workers. Non-restrictive rules of origin can help make SADC a platform for reducing costs and increasing the competitiveness of the region in the global economy.

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The SADC Trade Protocol: Towards a Resolution of Outstanding Issues on Rules of Origin

Agreement has yet to be reached on SADC rules of origin for a number of goods and sectors. In the absence of agreed rules, preferential trade cannot proceed in these sectors. This report outlines the outstanding issues and provides some analysis and commentary aimed at clarifying the implications of alternate solutions. It is intended to be read in conjunction with a companion Secretariat piece, *Consolidated Negotiating Text (No Agreement),* which provides a detailed listing of relevant sectors together with alternative proposals and some brief commentary.

The purpose of this background paper is not to reopen general debates on rules of origin, but rather to bring closure on outstanding issues within the framework already agreed. Nevertheless the analysis reported here might also contribute to a more general discussion of rules of origin and other related issues affecting the long-term impacts of the Protocol that will be undertaken in a review of the Protocol in 2004.

The Role of Rules of Origin

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

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

The second is explicitly foreseen in the Article 2 of the Trade Protocol that identifies the enhancement of economic development, diversification and industrialization of the region as a major goal. There is, however, considerable danger here.

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

According to the alternative 'open regionalism' approach, PTAs are seen as a platform from which the members can integrate more successfully and become more competitive in the

world economy.[1] The approach to rules of origin under this strategy is much different than that under the 'fortress' approach. In particular, it recognizes the importance of flexibility to source inputs internationally as well as domestically in order to promote investment and increase international competitiveness.

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

Authentication: Prevention of Tariff Jumping

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

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

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

Protection

Rules of origin have another incidental impact, which is to provide, intentionally or unintentionally, protection of particular industries or activities from regional competition. This can be of two forms.

- By depriving producers of access to raw materials or intermediate products from low cost international sources, strict rules of origin can raise the cost of producing a product for sale in the PTA.[2] They can be used deliberately to impede regional trade and competition under the PTA. They also can be rationalized as a defensive measure to protect producers in particular Member States from cost-raising effects of domestic policies on local sourcing of raw materials and intermediate inputs.

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[1] See Frank Flatters, *The SADC Trade Protocol: Impacts, Issues and the Way Ahead* Research Report prepared for USAID-funded SADC Trade Protocol Project, Gaborone Botswana, February 2001

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

Forcing regional producers to use high cost regional raw materials or intermediate inputs raises their production costs and can frustrate their ability to take advantage of regional preferences. In the case of manufactured goods with low MFN rates in partner countries, satisfying a restrictive rule of origin would actually put members of the PTA at a competitive disadvantage *vis à vis* non-members.[3] *In general, restrictive rules of origin can be a very effective way to shield existing producers from new competition (and to prevent consumers from benefiting from potential effects of regional tariff reductions).*

The defensive variation of this theme – the use of rules of origin to force potential regional competitors to operate under the same policy-induced handicaps as those in a particular Member State is similarly harmful. *At best it makes the PTA irrelevant for internationally competitive producers who source materials from the best international sources. At worst, it induces other member states to adopt high cost, internationally uncompetitive production methods, not for normal economic reasons, but simply to satisfy the rules of origin.*

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

The use of rules of origin for protective purposes is contrary to the spirit and intent of the Trade Protocol. To engage in liberalization of tariffs only to replace them with much less transparent and often more restrictive rules of origin is a retrograde step in trade and industrial policy design.

Trade liberalization is not an end in itself. Its intent is to increase opportunities for participation in the global economy and, more importantly, to secure stable and equitable growth for the citizens of the affected countries and regions. Restrictive rules of origin employed for protective purposes can be a serious barrier to increasing international competitiveness and to the achievement of these goals.

Other Uses of Rules of Origin

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

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[3] In such a case, of course, the regional producer would choose to forego the regional preferences and simply export to its partner under MFN rules. A strict rule of origin would then serve the main purpose of making the PTA irrelevant for its members' producers.

1. The Danger of Competition from 'Screwdriver' Assembly Industries

A frequently expressed concern of existing producers is that SADC free trade will foster 'screwdriver' or 'pure assembly' operations in neighboring countries that will become a source of unfair competition. Restrictive rules of origin, it is argued, will prevent this from happening.

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

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

Rule 3 makes it quite clear that the products of simple 'screwdriver' or pure assembly activities will not qualify for preferential tariff treatment under the Trade Protocol.

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

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

Rules of Origin in SADC: Processing of Certain Agricultural Products

Agreement has yet to be reached on the level of local content that should be required in a number of agricultural processing activities. The sectors that remain at issue are mixed spices, various milled grains, and certain preparations/products using milled or unmilled grains.

The side taken by any particular Member State on these issues generally depends on whether it is a significant producer of the raw material in question. Members that are producers of the raw materials and impose significant external tariffs on these products generally seek quite restrictive rules of origin (high regional content requirements), and those that are not major producers of the raw materials are happier with less restrictive requirements.

2. Safety and Dumping: The Case of Electric Cable

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

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

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

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

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

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

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

South Africa, Tanzania, Zambia and Zimbabwe have advocated restrictive rules of origin for wheat flour, as has Tanzania for mixed spices (on behalf of Zanzibar). Tanzania and Zimbabwe also advocated and secured approval of similar requirements for processed coffee as well as (and maybe unintentionally and only incidentally) tea and the whole HS chapter containing individual spices.

Encouraging Downstream Processing

One reason for high regional content requirements might be to encourage use of the products of the raw material producing members. However, this is not a compelling argument. In the case of wheat, even the largest regional producer, South Africa, is a net importer. Regional production of wheat is insufficient to meet regional demand.

In the case of coffee, tea and spices, the argument for a restrictive rule of origin to encourage regional downstream processing is even less compelling. Two of the keys to successful downstream coffee, tea and spice blending are a) sourcing a variety of high quality raw materials for blending purposes and b) efficient processing, creative packaging and marketing of the final products.

While some particular Member States are growers of high quality coffee or spices, none produce the range of varieties needed for blending and packing downstream products for international or regional markets. To be successful, coffee or spice-manufacturing exporters would need to source a significant share of their raw materials from outside of SADC. They would need to have easy and ready access to complementary imported materials.[4]

Despite the contribution of packaging to processing costs, even a 35 percent local value-added requirement would be very difficult to meet. The current chapter rule requires that at least 80 percent of the weight of the materials used be locally originating in order for a product to qualify for SADC trade preferences. *This rule would be impossible to satisfy, and so would rule out virtually all preferential SADC trade in such products.* Even Member States that might have some comparative advantage in spice blending and packaging by virtue of local availability of some of the necessary ingredients would be deprived of preferential access to SADC markets under this rule.

The only possible reason a spice blender in a particular Member State might wish to insist on such a restrictive rule of origin would be to ensure that other SADC producers would not have access to a protected local market. *In other words, the effect of the rule would be to promote local monopolies rather than encourage intra-SADC trade that might benefit Member State consumers.* The same argument applies to the identical rule that already has been agreed on coffee.

From the perspective of competitive international producers of raw materials – coffee, tea and some of the spices used in production of mixed spices – there would be no benefit from a restrictive rule of origin for the processed products. Consider the case of Tanzania, a competitive world producer and net exporter of coffee and cloves. Any diversion of its coffee or cloves to local or regional use would simply detract from international exports, with no net gain. The world price would obtain in either case. Furthermore, as already

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

demonstrated, restrictions of this sort are far more likely to discourage than to encourage any downstream processing activities. See Box 3 on South African fruit juice exports to COMESA as an illustration of the benefits of liberal rules of origin.

3. South African Investment and Export Opportunities in COMESA

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

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

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

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

Compensation for Protection-Induced High Costs of Raw Materials

In some cases, especially wheat and wheat flour, the main reason for proposed restrictive rules of origin is to compensate for the cost-raising effects on processing industries of protection of the raw materials in the producing countries.

High import tariffs on wheat in South Africa increase the cost of wheat milling in that country. Despite the advantages of location close to the domestic market and of large scale, efficient flour mills, South African millers would face a significant penalty in trying to compete in their domestic flour market against millers from partner countries that allow duty free (or low-duty) imports of wheat.

Deprived of the ability to provide protection of processing industries from intra-SADC competition through the use of tariffs, raw material producers seek protection through restrictive rules of origin.[5]

Unfortunately, the use of rules of origin to compensate for lost tariff protection would have a number of unintended and perverse implications.

[5] South African flour millers already receive considerable tariff protection in the local market. The tariff on flour significantly exceeds that necessary to compensate for the protection-induced high domestic cost of wheat. The result is that South African millers benefit from high levels of effective protection in their domestic market, despite the high domestic cost of wheat. There is evidence as well that South African wheat growers are actually being paid less than the landed, duty-paid cost of imported wheat, suggesting that the burden on millers due to the tariff on wheat is less than indicated by the wheat tariff itself. Furthermore South African millers are already able to compete in some regional markets despite the high domestic market price of wheat. This is because of duty rebates they receive on imported wheat that is milled for sale outside of South Africa.

- It simply replaces one form of protection for another, in contradiction to the goal of trade liberalization that lies at the foundation of the SADC Trade Protocol.
- It replaces a moderately transparent (and revenue-raising) tariff instrument with a distinctly non-transparent and non-revenue generating quantitative restriction on input use.
- A highly restrictive rule of origin limits the opportunities for and might even prevent entirely the blending of raw materials from different sources. The essence of spice and coffee blending, for instance, is the mixing of different types of spices and coffees. Strict rules of origin prevent this and thus have the unintended consequence of reducing rather than increasing the competitiveness of downstream processed products using local/regional raw materials.
- A SADC-wide restrictive rule of origin not only reduces competition, but also eliminates the possibility of trade that does not involve the raw material producing States. For instance, a rule of origin intended to protect South African flour millers in their domestic market prevents Mauritius or Mozambique millers from processing imported grains for sale under SADC preferential terms in Malawi or Namibia, despite the absence of any threat to South African millers.

A number of agricultural raw materials are produced in significant amounts in some Member States. As long as these Members wish to protect their raw material producers from international competition, and at the same time shield the corresponding processing industries from the higher costs resulting from this protection, it will be very difficult to achieve SADC free trade in these products.

Possible Solutions

In the case of wheat and wheat flour, a consensus is emerging in favor of a standstill on implementing SADC free trade in wheat and wheat products, at least for the wheat-producing Members. Under such a standstill, South Africa might simply exclude wheat flour for several years, leaving time for Member States to deal with other hindrances to intra-SADC trade and for the possibility of some resolution of global negotiations and rich-country policies on agricultural protection. There certainly seems to be a consensus that rules of origin are an inappropriate instrument for dealing with issues such as South Africa's desire to protect its wheat farmers.

The previously agreed strict rules of origin on tea, coffee and mixed spices seem to have been genuinely misguided, based on a fundamental misunderstanding of the interests of some or all the relevant producing Member States. Failure to achieve a satisfactory resolution of these issues will rule out preferential trade in SADC not only in these sectors, but also in downstream activities such as pasta and biscuits. The new proposal for some form of a 35 percent local value-added rule is still rather restrictive, but is much preferable from all perspectives to the previous rule.

A number of unresolved rule of origin issues remain in the manufacturing sector. The principal ones are in a few chapters – 84, 85 and 87. These chapters comprise the heart of what might be termed light manufacturing industry (machinery, electrical and electronic goods and components, vehicles and vehicle parts).

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

A number of different justifications have been provided for such strict rules. Many are based on the simple desire to protect existing industries against the possibility of increased competition arising from the freer trade in the region. The arguments for such protection range from vague fears of greatly increased and somehow unfair competition to more subtle defensive arguments based on the high cost of achieving existing levels of local content in the face of protective import regimes. The use of rules of origin as an instrument of protection is a far cry from their principal intent, to prevent simple 'tariff jumping'.

Import substitution industries in some Member States have been built up under the protection of high and cascading tariff structures and sometimes other incentives to increase local content. In some of these cases, rules of origin are seen as a complement to local content incentives and as compensation to local producers for the cost-raising effects of domestic content requirements.

There appear as well to be a number of instances in which Member States have expressed an interest in restrictive rules of origin as a form of insurance, 'just in case' they have local manufacturing activity that might be threatened under tariff-free preferential access by other Member States. In a number of cases this 'insurance' is unnecessary and misguided, not only because it violates the intention of using the Trade Protocol to promote freer trade in SADC, but also because they have no significant local industry to protect anyway.

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

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

The types of industries and firms represented in the sectors under review cover a very wide range. They include successful, internationally competitive exporters as well as protected import substitution producers. The successful exporters often occupy niche markets and rely on competitive access to imported raw materials and inputs. Nevertheless, they make major contributions to employment. Import substitution producers are often smaller. Their degree of dependence on imported materials varies considerably and depends on a number of industry specific factors as well as import policy regimes and other regulatory incentives.

The following discussion is divided into several sections based on HS chapter headings or groups of chapter headings.

Chapter 39: Plastics

The suggested rules of origin for plastics differ according whether the products in question are in the form of plastic raw materials or plastic products.

- For plastics in primary forms (HS 3901 to 3914) there had been agreement on a rule of origin that simply requires a single change of tariff heading. RSA has proposed an additional requirement, that no non-originating waste plastics be permitted in any of these categories.

- For plastic products, there are two proposals on the table – one demanding at least 40 percent local content, and the other at least 50 percent. Both of these proposals include the additional condition that the products contain no non-originating waste plastic.

  Plastic manufactures include a wide range of products, many of which are relatively labor intensive and involve relatively simple technologies. Other products are more skill and capital intensive. Many of these products are already subject to significant international import competition, mainly from non-regional sources. Some regionally produced products, however, are internationally competitive. The degree of local content in regionally produced products in this chapter varies across products. In all cases, however, the 40 percent local content requirement is more than sufficient to prevent simple tariff jumping. A requirement of 50 percent is not significantly different, but is, nevertheless simply an additional deterrent to regional trade and competition and as such is very difficult to justify.

The proposed prohibition of the use of non-originating waste plastic for both primary plastics and plastic manufactures is based on environmental arguments and has little or nothing to do with the prevention of tariff-jumping or with protecting local industry. The fear seems to be that if use of imported waste plastics is permitted in preferential SADC trade, the region might become a dumping ground for waste plastic products from elsewhere and there would be less incentive to reprocess regionally originating wastes.

Without in any way disputing environmental concerns about the problems arising from the disposal of waste plastics, it is important to observe that rules of origin are a distinctly inferior and ineffective tool for this purpose. Direct regulation, targeted taxes and other measures to control the generation, use, disposal and import of waste plastic are the appropriate tools for this purpose.

If there is a real environmental threat from a flood of imported waste plastic material, it is highly unlikely to be in the form of inputs into products for preferential intra-SADC trade; cutting off this particularly route would be no solution to the problem. The greatest fear is that processors might set up in a neighboring country to convert imported waste plastic into polymers (pellets) that would then be sold at a correspondingly low price and on preferential terms into another Member State. The availability of such low cost waste plastic products would undercut local incentives to collect and recycle domestic waste products.

The appropriate policy tool for dealing with such a problem would be domestic policies directly regulating the import of waste plastics. Member States might each wish to impose their own standards in this regard, and a SADC-wide rule of origin is would not be the appropriate tool for such this environmental purpose.

Furthermore, a rule of origin of this type would be extremely difficult, if not impossible, to enforce. The greater danger is that the rule would come to be used as a non-tariff import restriction when deemed convenient or when a Member State were faced with pressures for import protection by domestic producers. While use of imported waste plastics would be highly unlikely to give a significant competitive advantage to any regional producer, claims about violation of such a rule of origin would be a convenient way to block preferential imports of competing imports under the Trade Protocol.

The proposed restrictions on waste plastic would make little or no contribution to environmental quality, especially compared with alternative policies that could be used for this purpose. However, they might become a disguised form of protection for certain regional producers of plastics or plastic products. This does not make them desirable from the perspective of the goals of the SADC Trade Protocol.

Chapter 65: Hats

The general rule of origin agreed for HS Chapter 65 is that there be at least a single change of tariff heading – i.e. that all material used in the manufacture of goods in question be classified in a different HS heading. In the case of felt hats and other felt headgear (ex. heading no. 6503), and knitted or crocheted headgear (ex. heading no. 6505) alternative and more restrictive rules of origin have been proposed.[6]

The first of the alternative proposals, put forward by SACU, calls for double transformation (manufacture from yarn or textile fibres) and the other, put forward by Zambia and Malawi, would require 60 percent regional content by value. These are both extremely restrictive, and in particular are much more restrictive than the previously agreed chapter rule. No justification has been provided, in terms of the need for special provisions to deal with the possibility of tariff jumping for these particular products, or for special protection that cannot be accommodated through phasing of tariff reductions.

In the absence of any such justifications it is impossible to endorse the proposals for highly restrictive rules of origin for these two subheadings in HS Chapter 65.

Chapters 84 and 85: Machinery, Electrical Products and Electronics

Chapters 84 and 85 include many basic items of machinery, electronics and electrical appliances. A number of Member States have import substitution industries that manufacture such goods under significant external tariff protection.

Domestic incentive structures facing such industries – relatively high tariffs on final goods, lower tariffs on imported components or kits, and sometimes additional incentives to source some inputs locally—have encouraged the development of a number of high cost activities that are unable to compete internationally in terms of price or product quality. A major

[6] See *Consolidated Negotiating Text (No Agreement)* for a full description of the items in question.

reason in most cases is the small scale of production necessary to meet local market demand. 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.

Within these sectors are also a considerable number of internationally competitive export activities. 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 are generally of much greater importance in most sectors.

Exports account for a significant share of production in many such sectors, and also generate considerable of employment. A number of these are 'new exports' that have become more competitive due to MFN-based trade liberalization in the region over the past decade. *What were once inward-looking import substitution industries have become much more active players in global markets. This has generated many new jobs for workers in the region – far more in general than can be created in uncompetitive import substitution activities.*

There had been general agreement on a chapter rule for products in Chapters 84 and 85. For goods to qualify under this chapter rule, non-originating materials used in production 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 would have been 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, the Sandton Sub-Committee proposal permitting non-originating materials accounting for up to 65 percent of ex-works price remains on the table as well.

The actual degree of local content achieved in existing regional industries covered by these chapters varies considerably. Some industries have levels of local content that are less than those specified by the chapter rule, and many achieve considerably higher levels. In general, it is unlikely that the chapter rule will be a serious impediment to competitive trade for most existing industries. However, for some highly competitive global export industries in these sectors, a less restrictive rule of origin would undoubtedly enhance trading opportunities in the region. See Box 4 below on sourcing by internationally competitive exporters.

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

Some Member States have proposed a more restrictive rule of origin, including, generally a higher local content threshold of 60 percent, for a number of goods in Chapters 84 and 85.

In almost all cases the proposed amendments to the agreed chapter rule are in respect of goods that already are produced in the region, most usually in South Africa and/or Zimbabwe. In most cases it is SACU that has proposed the alternative, more restrictive rule.[7]

[7] SACU has proposed a rule of origin that would require at least 60 percent regional content by value (or more precisely a maximum non-originating content of 40 percent of ex-works price) for 11 of the 18 tariff categories

4. Rules of Origin and Internationally Competitive Exporters

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

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

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

As a result of their long experience supplying the South African mining sector, local producers have built up expertise in production of valves used in the mining industry, especially for the transport of slurry. This has generated a steady demand for these products from the mining industry around the world. Exports account for over one-third of total production.

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

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

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

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

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

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in Chapter 84. They have made a similar proposal in respect of 14 four-digit subheadings in chapter 85. See *Consolidated Negotiating Text (No Agreement)* for details.

In a small number of cases, a simple change of tariff heading rule has been proposed. And in one, television receivers, South Africa has proposed a rule requiring assembly from completely knocked down components.

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

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

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

Producers would not voluntarily engage in cost-raising methods of production unless government policies required it or provided some financial incentives for doing so. Assembly of products from CKD kits for sale in a protected domestic market is an example of a cost-raising activity encouraged by high tariffs on final products and lower tariffs on kits and components. See Box 5 below on refrigerator production in Mauritius.

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

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

When high levels of local content are motivated by cost savings and by efficient production rather than by responses to government edicts or incentives, existing producers have nothing to fear from competitors that might set up operations with lower levels of local content in the same country or in other SADC Member States. Even if changing technology or new marketing possibilities made lower local content production methods more competitive, existing producers would be better placed to adjust than new competitors. See Box 4 above on competitive export production in the valve and electric appliance industries.

5. Refrigerators: Rules of Origin and Benefits from Regional Trade Liberalization

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

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

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

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

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

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

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

The more restrictive rules of origin – especially the 60 percent local content requirement – proposed by SACU and others for a large set of products in Chapters 84 and 85 are similar to those required to qualify for preferential trade with the European Union (EU). The use of the same rule for EU trade might be thought to recommend it as an appropriate rule of origin for intra-SADC trade. Even if these rules of origin were appropriate for Africa-EU trade, they certainly would be far too restrictive to make sense in SADC. See Box 6 below on EU rules of origin.

6. EU Rules of Origin: An Appropriate Standard for SADC?

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

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

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

Using EU-based rules of origin as a standard for the SADC Trade Protocol would have the intriguing effect of disqualifying from SADC free trade preferences a wide range of goods that African producers export competitively to the EU!

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

The SACU proposals include as well a requirement for the local assembly ('population') of printed circuit boards (PCBs) in a wide variety of electrical and electronic products in these chapters. There is no justification for such a requirement in terms of the need to avoid tariff jumping or trade deflection.

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

To summarize the discussion so far, the prohibition of 'screwdriver' assembly operations together with the general chapter rule requiring 35 or 45 percent local content relative to ex-factory price is more than sufficient for authentication of origin of manufactured goods in these chapters. Additions to these requirements are at best unnecessary, and at worst will serve as a barrier to intra-SADC competition and make the SADC market irrelevant for many producers, especially those that are fully engaged and competitive in the international economy.

To impose stricter rules of origin would encourage certain small and inefficient import substitution industries and perpetuate high cost and non-competitive industrial structures. As such, this would hinder SADC's role in promoting free trade in the region and in becoming a

platform to increase the region's competitiveness in world markets. *Adopting the more restrictive rules of origin would be contrary to the principal developmental goals of the Trade Protocol.*

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

Without questioning in any way the importance of achieving these social and economic goals, a careful examination of the arguments would conclude that, as with the case of environmental objectives discussed earlier in connection with the disposal and regulation of waste plastics, rules of origin are not an appropriate instrument for these purposes. In fact, the use of SADC rules of origin for these purposes would be very costly and almost certainly ineffective. See Box 2 above for a discussion of these dumping and safety issues with respect to the case of electric cable.

Chapter 87: Vehicles and Vehicle Parts

SACU has proposed a general rule for chapter 87 requiring 60 percent regional content (or a maximum level of non-originating materials of 40 percent of the ex-works price). At the same time, it has been proposed that detailed rules be set at the four digit subheading level.

SACU has promised to put forward alternative proposals for six of the nine tariff subheadings in the chapter (8701 to 8704 and 8706 to 8708 – tractors, motor vehicles of various types, chassis and bodies). Detailed recommendations are still awaited.

In the case of motorcycles (8711) Mauritius has proposed a rule requiring 35 percent regional content (or a maximum level of non-originating materials used of 65 percent of the ex-works price). On the basis of investigations to date, it appears that this would be more than adequate to provide authentication of origin for intra-SADC trade. In the absence of any other proposals for the remaining subheadings in this chapter, we would recommend adopting this Mauritius proposal for subheadings 8709 to 8716 as well.

Chapter 90: Optical, Scientific and Other Equipment

Chapter 90 covers a wide range of optical, photographic, scientific and medical equipment. Very few items in this chapter are produced in SADC. On the basis of a desire to reduce competition for an optical fibre producer, and a syringe maker, SACU has proposed a chapter rule stipulating 60 percent local/regional content by value. Mauritius has recommended a more reasonable and less restrictive rule of 35 percent local content.

A very wide variety of goods is represented in this chapter. According to all the information provided, only two firms producing very specialized products are claimed to require a more restrictive rule. At least one of these firms is internationally competitive and exports a large proportion of its output. In light of all these considerations, the less restrictive rule, requiring 35 percent local content, would be more appropriate at the chapter level. If SACU wishes to recommend a more restrictive rule for a particular product in this chapter, the argument and evidence for this position could be reviewed.

Chapter 94: Furniture, Lamps, Prefabricated Buildings, etc.

This chapter also covers a very wide range of products. A chapter rule allowing the use of non-originating materials valued up to 65 percent of ex-works price has been agreed. South Africa has argued that agreement has not yet been reached at the subheading level and wishes to propose alternative rules for medical, surgical, dental or veterinary furniture, etc. (9402) and for two items in 9403 (other furniture and parts thereof (ex 9403.10) and other metal furniture (ex 9403.20)). No justification for this position has been received to date.

Conclusion

Rules of origin are required in any preferential trading arrangement in order to authenticate goods as truly originating in a country that is intended to benefit from the preferences in question. In SADC, this *authentication function* is achieved through both

- regulations that specifically ensure that simple mixing, packaging, assembly and relabelling activities do not confer origin, and
- detailed rules on the amount of regional content and/or processing that are necessary to confer originating status for specific products.

Rules of origin also encourage certain economic activities by *protecting* regional producers from external competition.

In many of the sectors where agreement has not yet been reached in SADC, proposed rules of origin are far more restrictive than necessary to serve their authentication function, and have the additional effect of providing high levels of protection to particular regional producers.

The use of rules of origin to protect certain activities will raise costs and reduce the international competitiveness of SADC industries. Rules of origin as currently formulated have the potential to make the Trade Protocol irrelevant for the development of the region and, even worse, to turn SADC into a protected fortress – a fortress of non-competitive industries focusing on a market, for sales and for sourcing of inputs, that is smaller and no more developed than Turkey.[8]

Experience internationally and in SADC itself shows that the development of internationally competitive industries requires flexibility in the sourcing of raw materials and intermediate inputs. An environment that encourages this flexibility is a key element in fostering the investment necessary for the region's long-term development and for the generation of badly needed employment opportunities for its workers. Non-restrictive rules of origin are essential for the fulfillment of SADC's role as a platform for reducing costs and increasing the competitiveness of the region in the global economy.

[8] See Frank Flatters, *The SADC Trade Protocol: Impacts, Issues and the Way Ahead* Research Report prepared for USAID-funded SADC Trade Protocol Project, Gaborone Botswana, February 2001.