Wheat Flour in SADC:
Rules of Origin, Tariff Preferences and Competition

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Summary

There are several proposed rules of origin under consideration for regulating trade in wheat flour and its products under the SADC Trade Protocol. The main issue in deciding among them is whether use of regionally grown wheat should be a condition to qualify for SADC tariff preferences.

Discussion of these alternatives has been diverted by questions about the need to protect local grain growers against unfair, subsidized international competition, about the implications of such protection for downstream millers, and by questions about wheat growing capacities in SADC, including whether SADC is or could be self-sufficient in wheat.

Insufficient attention has been paid to the actual operation of wheat and flour markets in the Member States. A closer examination of these markets reveals some surprises and yields some simple conclusions about the implications of alternative rules of origin.

- Contrary to a myth perpetuated by the milling industry, current import duties on wheat in South Africa, the major wheat-growing SADC Member State, provide no protection to domestic grain growers. Thus they impose no cost burden on the local milling industry. A restrictive rule of origin requiring the use of regional wheat to qualify for SADC tariff preferences for flour would simply preserve the current situation and be of no benefit to grain farmers.

- The regional milling industry is dominated by a few large players which benefit from very high levels of protection due to import duties on flour in most markets. A rule of origin requiring use of regionally grown wheat would negate the competitive effects of preferential SADC tariff reductions by imposing a condition that could not be met by millers outside of South Africa. It would preserve regional milling oligopolies that generate substantial rents and/or waste by a few investors, at the expense of consumers of flour products, especially bread.

- Heavily back-loaded tariff reduction schedules in most non-SACU Member States, together with a variety of non-tariff import barriers (NTBs) on flour in SACU and elsewhere, will preserve and prolong milling monopolies or oligopolies unnecessarily, with consequent further accumulation of rents by millers and penalization of consumers of bread and other flour products.

These findings lead to the following recommendations.

- Speedier and more symmetric preferential tariff reduction schedules, together with a simple, unrestrictive rule of origin for flour (change of tariff heading) would increase competition in the regional milling industry, put all players on a level playing field, and permit the SADC 'free trade' arrangements to yield some benefits from increased

competition and lower prices of a basic consumer staple. This would cause no harm to regional grain growers.

- For downstream products of wheat flour such as pasta and biscuits, a rule of origin requiring a simple change of tariff heading would be sufficient to ensure that tariff preferences are granted only to products that result from substantive economic activity in the region. A more stringent requirement that these products be made with flour milled from regionally grown wheat would make the SADC Trade Protocol irrelevant for these sectors, despite the international export competitiveness of a number of regional producers. As a practical matter, most flour made from imported wheat that is used in these sectors is actually milled in the region. Therefore a double transformation requirement – that wheat used in these products be milled in the region (but not necessarily from domestic wheat) – would not be a serious impediment and therefore would be the recommended alternative at the moment.

Wheat Flour in SADC:
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1. Background

Rules of origin for preferential trade in wheat flour and its key products under the SADC Trade Protocol have been under discussion for a long time; agreement has not yet been reached. In the absence of agreed rules, preferential trade cannot take place.

The SADC Committee of Ministers of Trade approved the establishment of a Committee on Wheat and Flour in June 2000. The Committee met in Mauritius in August 2000 and at the Kopanong Conference Centre in Benoni, South Africa in February 2001. At Kopanong the Technical Committee on Wheat considered the divergent positions on the rules of origin for wheat and wheat products of chapter 11 and chapter 19, and recommended that a study be undertaken.

The objectives of the proposed study were described as follows.

> *To establish current and projected wheat and wheaten product production, processing and consumption within the SADC region with a view to establish a trade mechanism (specifically rules of origin) that optimally benefits the region as a whole whilst taking into account distortions in the world market for wheat and wheat products.*

The SADC Secretariat carried out this study, including consultations with many SADC stakeholders, and prepared a draft report on the implications of various proposed rules of origin for wheat flour and its products. The report was presented and formed the basis for discussions at the First SADC Roundtable on Rules of Origin in Gaborone on June 18-20 2001.

The SADC Ministers responsible for trade also considered these proposals at Maputo in July 2001 and agreed to give the Member States time to consult with stakeholders and competent authorities on the options presented.

As a result of these discussions the Secretariat undertook to prepare a final report that reflected the findings of the research for the Roundtable document, inputs provided by Roundtable participants, and the results of any additional research and stakeholder consultations aimed at further clarification of the issues.

This report is the result of the Secretariat's initiative.

2. Introduction to the Issues

There have been two longstanding proposals for the rules of origin for wheat flour (Ex HS chapter 1101). These are:

Proposal 1: *Manufacture in which at least 70 per cent by weight of the material used must be wholly obtained.*

Proposal 2: *Manufacture in which the value of all the materials used does not exceed 65 per cent of the ex-works price of the product.*

In Mauritius Option 1 was supported by SACU, Tanzania, Zambia and Zimbabwe, while Option 2 was endorsed by Mozambique, Mauritius and Malawi.

Subsequently, a further proposal was put forward by Mozambique. The proposal was identical to Option 2, with the addition of two conditions: that preferential trade be quota-limited and that it be subject to expiry if and when regional wheat producers are able to meet all regional demand.

Decisions on rules of origin for downstream flour products such as pasta and biscuits (contained in HS Chapter 19) have awaited final determination of rules on flour. However, a number of the rules that have been proposed are at least as restrictive as the most stringent ones that have been suggested for flour. That is, some stakeholders have proposed rules for pasta and biscuits that would require that flour and all wheat used in its manufacture be sourced in the region.

These proposals must be 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 self-sufficient. Others produce almost no wheat at all. 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. It is useful as well to bear in mind that the regulatory environments facing these industries in at least some Member States have undergone rapid and significant change in recent years.

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 tended to resist liberalization of intra-SADC trade. In particular, they have tried to insist on 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 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.

A great deal of the debate about rules of origin in these sectors has centred on wheat. How much is wheat growing 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? Much of this discussion has taken place against the

background of well known distortions in international wheat and flour markets as a result of protection and subsidy policies in major producing countries.[1]

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? Less attention has been paid to the implications of these policies and of alternative arrangements for trade liberalization under SADC 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.

Less openly discussed, but of equal or maybe even greater importance have been questions about the types and extent of existing protection of milling industries in SADC. How much protection is currently enjoyed by different SADC milling industries? How will this protection be affected by free trade under different rules of origin? What are the implications of the use of non-tariff import barriers on wheat flour and its products in a number of Member States and what plans are there for phasing these out as part of the SADC trade liberalization process? What is the rationale and what are the implications of differences in the tariff phase-down schedules among the Member States?

In the context of many of these issues, rules of origin have tended to be the instrument of last resort for Member States or stakeholders that are dissatisfied with other dimensions and perceived inequities of the Trade Protocol. As a result, rules of origin are being proposed for all kinds of purposes that are unrelated to their true economic purpose – to authenticate that goods claiming SADC tariff preferences actually result from economic activity in a qualifying Member State.[2]

3. The Market for Wheat and Wheat Flour in SADC

Wheat is by far the most important element in the cost of flour production. Although there are other minor inputs, the remaining costs are primarily labour and capital.

SADC is not self sufficient in wheat production. Outside of South Africa and Zimbabwe, only modest volumes of wheat are produced within SADC. Indeed even in South Africa and Zimbabwe it is necessary to import wheat in order to meet the requirements of the flour millers. Within SADC wheat is also grown in Lesotho, Tanzania and Zambia. Estimated production, consumption and import requirements are shown in Table 1.

For a number of reasons, including data collection difficulties and annual production variations arising from climatic and other conditions, these figures are indicative only. Nevertheless, certain broad patterns can be discerned from this and other data examined in the conduct of this study.

[1] While these policies might be unfair to SADC wheat producers, they also provide potential benefits to consumers and users of these products in SADC. It needs to be recognized, however, that these distortions in world markets are far beyond the control of SADC or its Member States. For the purposes of policy decisions at the SADC level, they must be treated as exogenous.

[2] See Frank Flatters "The SADC Trade Protocol: Outstanding Issues on Rules of Origin" USAID-funded Research Report prepared for SADC Secretariat.

Table 1
Wheat Consumption, Production, Imports and Exports in SADC

Country	Consumption ('000 tons)	%	Production ('000 tons)	%	Imports ('000 tons)	%	Exports ('000 tons)
Botswana	78	2	1	0	81	4	3
Lesotho	70	2	5	0	74	4	9
Malawi	60	2	2	0	58	3	0
Mauritius	103	3	0	0	133	7	30
Mozambique	180	5	0	0	180	10	0
Namibia	60	2	6	0	57	3	3
South Africa	2,500	64	1,800	79	830	44	130
Swaziland	40	1	0	0	40	2	0
Tanzania	250	6	90	4	190	10	30
Zambia	115	3	70	3	45	2	0
Zimbabwe	420	11	300	13	190	10	70
Total	3,876	100	2,274	100	1,878	100	275

Source: Figures based on information received during interviews and from SADC-FANR, National Chamber of Milling, Food Balance Sheet and SAGIS.

Required imports of wheat in SADC have been increasing over the past decade. This trend is expected to continue since demand for wheat flour is income elastic and there are very limited prospects for growth of internationally competitive wheat production in the region.[3] Indeed the production of wheat within South Africa could be expected to decline if the current levels of protection were to be reduced. South Africa, Zambia and Zimbabwe all supply more than 60 per cent of their total domestic requirements for wheat. Tanzania supplies 36 per cent and all the remaining SADC countries grow less than 10 per cent of their total domestic requirements. Three countries – Mauritius, Mozambique and Swaziland – grow less than one per cent of their total domestic requirements.

Over the past twenty years the majority of SADC Member States have provided import protection to domestic flour producers. In many countries wheat flour and wheaten products have been protected by a combination of both tariffs and non-tariff measures. Table 2 shows current MFN duty rates on imports of wheat and wheat flour in SADC.

South Africa and Tanzania, both wheat producing Members, provide significant tariff protection to domestic wheat growers. Zambia and Zimbabwe, the other two wheat-growing Members levy only modest tariffs on wheat imports. With the exception of Mozambique, which imposes a modest 2.5 percent tariff, none of the other Members levy import duties on wheat. The zero wheat tariff Members include the BLNS countries, despite their membership in SACU and hence their commitment to a uniform import duty regime with South Africa. Zero tariff treatment in these cases is achieved through a duty rebate program aimed at maintaining world price parity for this basic foodstuff.

[3] There have been many discussions and some agronomic studies of the wheat growing potential of the region. These have resulted in claims that growing conditions in certain regions would support a 'wheat belt' capable of meeting all of southern Africa's wheat demands. Regardless of the agronomic merit of such claims, there is no possibility that such production increases would be an *economic* proposition in any foreseeable future. More importantly, as will be seen in the discussion below, such arguments are irrelevant to the choice of a rule of origin for wheat flour trade in SADC.

Table 2
Most Favoured Nation Tariffs in SADC

Country	MFN Tariff On Wheat	MFN Tariff On Flour
Botswana	0	10% + R294/ton
Lesotho	0	10% + R294/ton
Malawi	0	0%
Mauritius	0	15%
Mozambique	2.5%	30%
Namibia	0	10% + R294/ton
South Africa	R196/ton	10% + R294/ton
Swaziland	0	10% + R294/ton
Tanzania	25%	25%
Zambia	5%	25%
Zimbabwe	5%	40%

Note: The *ad valorem* equivalent of the current SACU duty on flour is 22 percent at current prices; for wheat it is 13 percent.

With the exception of Malawi and Mauritius[4], all Member States impose significant external import duties on flour imports. The SACU import duty on wheat is tied to its world price and is designed to set a minimum domestic price equal to its 'long run average' in world markets. The current duty is R196 per ton. The SACU import duty on flour, in turn, is tied to that on wheat and, as will be seen below, is more than sufficient to overcome any alleged cost penalty imposed on South African flour producers by import duties on wheat. (A more detailed discussion of the South African import regimes for wheat and flour is provided in Section 4.1.1 below.)

A number of Members, including South Africa, also provide duty rebates on flour used in exports produced by domestic millers. This is designed to permit them to compete in regional markets with millers in other countries that might benefit from free access to wheat on world markets.

Table 3
Date of Elimination of Import Duties on Wheat and Flour in SADC

Country	Wheat Imports from		Flour Imports from	
	RSA	Non-RSA	RSA	Non-RSA
Malawi	Now	Now	Now	Now
Mauritius	Now	Now	2012	2007
Mozambique	2015	2012	2015	2008
SACU	NA	2004	NA	2004
Tanzania	2012	2008	2012	2012
Zambia	2006	Now	2012	2012
Zimbabwe	Now	2006	2009	2012

Source: SADC Secretariat, based on official offers of Member States.

In addition to the wide variation among Member States in current MFN tariff structures, there are similar differences in their SADC tariff phase-down schedules. Table 3 shows the year in

[4] Mauritius achieves world price parity for flour through its State Trading Corporation which purchases flour on the basis of highly competitive international tenders.

which preferential tariff rates offered on wheat and flour go to zero in each of the Member States. Malawi and Mauritius already have zero rates and so their SADC phase-downs are immediate.[5] The SACU phase-down will be complete buy 2004.[6] In all other Member States, those with the high MFN rates on these products, the phase-down will be achieved over a much longer time period. With the exception of Zimbabwe, no Member will eliminate its tariff on flour imports from South Africa before 2012.

Wheat and wheat flour are also protected by the natural barriers arising from transport costs and, in a number of Member States, by non-tariff import barriers (NTBs).

Wheat costs about $17 per ton to transport from North America and more from other sources. This provides natural protection for locally grown wheat. The cost of shipping flour from Australia or Europe is at least twice this much. For flour millers, the net effect of these transport costs is a significant amount of natural protection from import competition. (See Section 4.1.2 below.) Such protection is even greater for mills located away from seaports.

Non-tariff import barriers on wheat flour include the following.[7]

- Botswana and Namibia impose a local purchase requirement on the right to import wheat flour. Import permits are not granted unless equivalent purchases are made of locally produced flour. This requirement provides a captive market for local production, permits the price of local flour to be higher than it otherwise would be, and hence gives protection to the local industry.
- Swaziland also has an import permit system. All flour imports require a permit that must be granted by the National Agricultural Marketing Board. The Board restricts the number of permits granted.
- Mauritius controls all wheat flour imports through its State Trading Corporation. The corporation purchases flour for sale in the domestic market through competitive international tenders and then sells the flour at a discount of 5 percent relative to its purchase price. This system is designed for the benefit of domestic consumers and provides no protection to local millers.
- Zimbabwe has an import licensing scheme for wheat and wheat flour. These schemes are designed to protect domestic producers.
- South Africa has recently announced a vitamin enrichment program for wheat flour. All domestically sold wheat flour must be vitamin enriched as prescribed by the Ministry of Health. Regardless of the intention of the program, it has the incidental cost of raising the cost of producing flour for sale in the South African market. While it applies equally to South African and non-South African producers, it imposes a relatively greater cost burden on smaller producers and those selling only relatively small shares of their production in the South African market.
- Zambia imposes tight SPS inspections on wheat flour in transit to DRC.

[5] Mauritius does not phase down its flour duties until 2007 (non-RSA) and 2012 (RSA). However, the State Trading Corporation tender policies make these tariffs irrelevant.
[6] In fact, according to schedules published in the Government's official gazette, South Africa's phase-down will be complete by 2003, one year earlier than promised in their SADC offer.
[7] This list is based on material obtained from many sources in the course of investigations for this report. It is unlikely to be fully accurate, complete or up to date. However, it should suffice to provide a picture of general patterns and of the variety of barriers in place. Further inputs from stakeholders and Member States in updating this list would be very helpful.

- Zambia also imposes a substantial cash deposit requirement on wheat flour in transit. This and the previous measure increase the cost to other countries of exporting flour to DRC, presumably giving an advantage to Zambian producers in accessing the DRC market.

In light of the high rates of tariffs and other import barriers, the bulk of flour production in most Member States is sold in their domestic markets; there is very little intra-SADC trade. Malawi generally accounts for a large share of intra-SADC imports of flour, and Mauritius for its exports. Zimbabwe trade data show her to have been both an importer and exporter of flour within SADC. Small amounts of trade also occur between Zimbabwe and Zambia, and South Africa has exported small amounts to a number of Member States.

4. Analysis of Import Regimes for Wheat and Flour in SADC

Most flour-milling industries in SADC have developed behind protective barriers. The form of protection includes tariffs (South Africa and other SACU Members, Mozambique, Tanzania, Zambia and Zimbabwe), import licensing (Botswana, Namibia, Swaziland and Zimbabwe), and other controls (e.g the Mauritius State Trading Corporation). These regulatory environments will be a major determinant of the ultimate effects of alternative approaches to intra-SADC trade liberalization.

South Africa is by far the largest wheat producer in SADC, and the special issues arising from South Africa's wheat sector have played a major role in trade negotiations in this and related sectors. Therefore it is important for all Member States to appreciate the South African position. For that reason, this report pays special and more detailed attention to the South African case.

At the same time, there are important issues related to the regulatory and import regimes in other Member States that will play a major role in shaping the implementation of the Trade Protocol. These must also be understood by all the relevant stakeholders.

4.1 South Africa

Prior to 1996 wheat, wheat flour and bread and other downstream products were heavily protected and/or regulated in South Africa. Since the mid 1990s these markets have undergone considerable deregulation and liberalization. The key remaining features of direct relevance to this study are the systems of import protection applied to wheat and wheat flour.

4.1.1 Outline of the Current Protection Structure

Wheat imports are currently subject to a specific import duty whose value is tied to the international import price in the following manner. When the current import price is below its 'long term average' of $157 per ton (fob Gulf for hard red winter wheat),[8] the duty is the

[8] This price was determined as a 10-year average in 1998. Hard red winter wheat was chosen as the comparator because of its preponderance in world markets. Since 1998, the international price has been consistently and significantly below this 'long term average'.

difference (in Rand) between $157 and the actual price per ton.[9] When the current price exceeds $157, the import duty is zero. In other words, the import duty is set to bring the price of imported wheat to at least $157 per ton (plus transport costs). It is intended to set a floor on the domestic price of wheat in South Africa.

The import duty on wheat flour is also set as a specific rate that is directly related to the duty on wheat. Based on the assumption that through the milling process R100 worth of wheat produces R150 worth of flour,[10] the duty on flour is set at 1.5 times the duty on wheat. In addition, as a form of adjustment assistance to millers, the duty is augmented by a certain percentage of the price of flour. The additional import duty was set at 40 percent in 1998, was reduced to 30 percent at the end of 1999, 20 percent at the end of 2000, 10 percent in December 2001 and will fall to zero by January 2003. It is currently 10 percent.

With an international wheat price of $130 per ton (its approximate level in February 2002) and the current 10 percent mark up on the flour duty, the *ad valorem* equivalent duty rate on wheat is about 21 percent and on flour is about 27 percent.[11] The import duties on flour are more than sufficient to compensate millers for any possible cost-raising effect of duties on wheat.

4.1.2 Effective Protection of Flour Millers in the Domestic Market

The rate of *effective rate of protection* measures the net protective effect on millers of the import protection on flour and on wheat. It is an estimate of the proportional increase (or decrease) in domestic value added per unit of output afforded to domestic producers relative to what would prevail under free trade in all inputs and outputs. Thus it is an indicator of the cushion provided by protection for higher costs of domestic production and/or of the size of the economic rents made possible by protection, relative to those in normal international production. See Box 1 on effective protection.

The effective protection to flour millers selling in the domestic market in South Africa depends on the net effect of any negative protection arising from import duties on wheat and the positive protection arising from the duties on imports of flour. *Since the ad valorem equivalent rate on flour is substantially higher than on wheat, the net impact is highly beneficial to flour millers. That is, the import duty structure gives substantial protection to South African wheat millers selling in the domestic market.*

Furthermore, there is considerable evidence that the import duties on wheat provide very little benefit to local grain growers. Under current market conditions, the domestic price of wheat is equal to or even less than the price of equivalent imports before tariff. Thus, the

[9] The actual import duty is adjusted in discrete jumps; it is adjusted only when the world price changes by more than $10 relative to its previous basis. At the moment (February 2002), therefore, the import duty is not sufficient to raise the import price to $157.

[10] This is a rule of thumb based on the alleged capabilities of relatively efficient international millers. In fact, most internationally competitive millers are able to achieve a conversion rate (in value terms) of 1.4 or less. The estimates of effective rates of protection below are designed to be consistent with a rate of 1.4.

[11] These rates for South Africa are based on strict application of the formulae at each world price considered. In fact, because of 'stickiness' that has been built in to the adjustment of the tariff to changes in world prices, the actual import duties are a little bit different than this. In Table 8 of Section 4.2 below we include calculations based on the actual current tariff rates on wheat and flour.

import duties on wheat impose little or no burden on South African millers, at least in respect of domestically purchased wheat.[12]

1. The Concept and Measurement of Effective Protection

Import duties or other import barriers generally reduce competition and raise the prices of protected goods in the domestic market. For sectors in which the taxed or restricted goods are outputs, this is a source of positive protection. For sectors in which the goods are inputs, this raises costs and results in negative protection. If a sector produces a good that is protected, and at the same time uses protected inputs, the net effect of the system of protection could be either negative or positive.

The *effective rate of protection (ERP)* is a commonly used measure of the net effect of protection of inputs and outputs. The ERP measures the percentage increase in domestic value added in any activity that is made possible by the structure of protection of both inputs and outputs.

The concept is best illustrated with a few examples. Each of these examples closely reflects the actual situations in the milling industries of SADC Member States (see Table 8 in Section 4.2 below).

Suppose that at international prices and in a typical international flour mill wheat accounts for 71 percent of the final value of flour produced. Abstracting from other intermediate inputs, this means that $100 worth of flour requires purchased inputs (wheat) worth $71. The value added in flour milling, therefore, is $29. It includes the cost of labour and all other inputs, including all costs of and a normal return to capital. This is referred to as *value added at world prices, VAW.*

Example 1: Consider mills in a country with import duties of 2.5 percent on wheat and 35 percent on flour. These import duties would normally raise the domestic price of wheat by 2.5 percent and of flour by 35 percent, relative to world prices. The domestic cost of wheat required to produce flour worth $100 in world markets would be $72.78 (2.5 percent more than $71). The value of the flour produced would be $135 at domestic prices (35 percent more than $100).

The net effect of the tariffs on wheat and flour, therefore, is to permit domestic millers to produce flour at significantly higher cost than international mills. Domestic processing cost could be as great as $135 - $72.78 = $62.22 and millers could still compete against international suppliers. The difference between the domestic value of flour produced and the domestic cost of the necessary wheat inputs is known as *value added at domestic prices, VAD.*

The *effective rate of protection* due to import duties on inputs and outputs is defined simply as the percentage change in value added permitted by these import duties:

$$ERP = ((VAD/VAW) – 1)*100$$

For the structure of protection in this example, value added is increased by 115 percent (the difference between VAD ($62.22) and VAW ($29)). Effective protection to flour milling is 115 percent.

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[12] This is based on a wide variety of sources including direct comparisons of actual wheat import prices and South African grain futures contract prices, and data from informed sources within the milling industry and the South African farming community. Millers from some BLNS states claim that they are often able to source wheat more cheaply from South African growers than from imports, despite the duty rebate they receive on imported wheat. There are several possible explanations for this phenomenon (domestic prices significantly less than duty-paid import prices). Some observers point to the much greater market power of millers than farmers due to the concentration of the former relative to the latter. Another possibility is that competitive pressures on major South African millers from more efficient producers, some of whom have access to wheat at import parity prices, puts severe downward pressure on how much they are able to pay for local wheat.

Domestic millers can have processing costs that are 115 percent higher than in normal international mills and still compete against imports in the domestic market. Alternatively, if domestic mills can produce with similar processing costs to foreign mills, they can reap excess profits equal to 115 percent of their local processing costs, including the cost of labour and normal returns to capital.

Example 2: Suppose that the country imposes import duties at a rate of 30 percent on both wheat and flour. In this case the domestic cost of wheat is increased from $71 to $92.3 and the value of the flour it can produce rises from $100 to $130. Domestic vale added with these import duties in place is $37.7 ($130 – $92.30). VAW with these tariffs is $37.70. Comparing this with VAW of $29 ($100 – $71), it is seen that the percentage increase in domestic value added permitted by protection of 30 percent on both wheat and flour is also 30 percent. Effective protection is 30 percent.

Domestic millers can have processing costs that are 30 percent higher than in normal international mills and still compete against imports in the domestic market. If their processing costs are similar to those of foreign mills, they can reap excess profits equal to 30 percent of their local processing costs, including cost of labour and normal returns to capital.

Example 3: Suppose that flour can be imported with no import duty, but there is an import tariff of 5 percent on imported wheat. The domestic cost of wheat is increased from $71 to $74.55. The domestic value of the flour produced is the same as in the rest of the world, $100. Therefore domestic processing costs cannot exceed $25.45 ($100 - $74.55) for local millers to compete against imports. VAD is $25.45, compared with VAW of $29. This means that effective protection is negative. VAD is 12 percent less than VAW; the effective rate of protection to domestic millers is -12 percent.

Domestic millers need to be able to mill flour with processing costs 12 percent less than in a normal international mill in order to compete against imports.

The three examples are summarized in Table 4.

Table 4
Summary of Effective Protection Examples in Box 1

World Values		Domestic Values				ERP Calculation		
Wheat Value ($)	Flour Value ($)	Wheat Duty (%)	Flour Duty (%)	Wheat Value ($)	Flour Value ($)	VAW ($)	VAD ($)	ERP (%)
71	100	2.5	35	72.78	135	29.00	62.22	115
71	100	30	30	92.30	130	29.00	37.70	30
71	100	5	0	74.55	100	29.00	25.45	-12

Table 5 shows estimates of the current rates of effective protection for South African millers producing for sale in the domestic market. World wheat prices prevailing over the past year have been in the range of $125 to $135 per ton and are currently a little less than $130.

The estimated effective protection rates shown in this table abstract from the 'natural protection' provided by the cost of international transport of wheat (giving negative protection) and flour (giving positive protection). At current transport costs of $17 per ton for wheat and $33 per ton for flour, the net protection afforded by transport costs is about 20 percent. In other words, the total effective protection enjoyed by millers in South Africa is at least 20 percentage points higher than the rates shown in Table 5. This is a substantial amount of additional protection, due only to the unavoidable effects of transport costs.

Subsequent calculations and analysis abstract from this source of protection in South Africa and in other SADC Member States.[13]

Table 5
Effective Protection to Flour Milling in South Africa (%)

World Wheat Price	% of Wheat Tariff Borne by Millers			
	100%	70%	40%	0%
$125/ton	49	68	86	110
$130/ton	48	63	79	99
$135/ton	46	59	72	88

The first column of Table 5 shows the effective protection provided to flour millers on the assumption that the full amount of the wheat tariff is passed on to millers. Under this assumption, it can be seen that the effective rate of protection provided by the current protection structure on wheat and flour is 46 to 49 percent. That is, South African millers can have non-wheat production costs that are nearly 50 percent higher than foreign competitors in SADC or elsewhere (even if they have access to wheat at world prices) and still compete against imports in the domestic market. Alternatively, if they can produce as efficiently as millers in other markets (and there is no reason that this should not be the case) they can make excess profits of almost 50 percent of normal production costs (including a normal return to capital). In other words, this is a measure of the potential economic rents, or excess profits, due to this protection.

If, as is apparent from recent evidence, the import duty on wheat is not fully passed on to millers, the effective rate of protection is even higher. The second to fourth columns show the effective protection rate under different assumptions in this regard. If, for instance, only 70 percent of the wheat duty is passed on to the millers in the form of higher wheat costs, their effective protection becomes 59 to 68 percent at current wheat prices. If none of the tariff is passed on (i.e. if domestic growers are paid only the world price), effective protection given to flour millers is about 100 percent (88 to 110 percent). This is the scenario that best fits current circumstances in South Africa.

Such a structure of protection provides room for large inefficiencies or very sizable economic rents for local millers in South Africa. In either case, the ultimate burden is borne by South African consumers of flour, bread and other flour products. This is especially costly and

[13] Two other assumptions had to be made to get these estimates. The two together are necessary to estimate the share of wheat in the cost of flour at world prices. The first is the wheat-to-flour conversion rate which we have taken as 1.2; that is, it is assumed that 1.2 tons of wheat are required to produce 1 ton of flour. Second, it is assumed that the share of wheat in total flour production costs at 'normal' world prices is 75 percent. These two assumptions imply a ratio of the price of wheat to the price of flour (at world prices) of 1 to 1.4. This is certainly consistent with general international evidence and with studies done by the South African Board of Tariffs and Trade (BTT Report No. 3932 "Revision of the Tariff Dispensation on Wheat, Wheaten Flour and Products Thereof", Table 12). The wheat to flour conversion ratio is also consistent with data on South African mills taken from the same study (Table 11). These assumptions also imply a wheat price to flour price ratio of 1.8 in South Africa at current market prices. This is consistent with information provided by the South African Department of Trade and Industry (DTI). Finally, the assumptions suggest a share of wheat in South African flour milling costs of about 71 percent, which is virtually the same as estimates provided by the South African Association of Millers.

regrettable in light of the government's recently announced intention to use bread and other flour products as vehicles for improving basic nutrition for the young and the poor.

What would happen to this protection under intra-SADC free trade in wheat and wheat flour?

As already mentioned, intra-SADC free trade in wheat would not have any direct effect on wheat prices in South Africa. It is the world price of wheat, together with competitive conditions in the domestic market that will remain the principal determinants of the price of wheat in South Africa. As long as SACU tariffs on wheat remain unchanged, the local price of wheat will be unaffected by intra-SADC free trade. In fact, if the domestic wheat price is already at or below import parity, as certainly appears to be the case at present, it also will be unaffected by changes in the import duty on wheat.

What happens to competition in the local market for flour will depend in large part on what rule of origin is chosen.

Under proposed Option 1, a very restrictive rule that would require the use of local wheat for flour to qualify for SADC tariff preferences, SADC free trade would bring no significant new competition to the South African flour market. The situation would remain as at present, with South African millers receiving effective protection of about 100 percent at current world wheat prices (see last column of Table 3).

Under proposed Option 2 that permits preferential access to the SACU market for flour milled from imported wheat, South African millers would face two quite different types of competition.

- For wheat flour *from non-SADC sources* the situation would be the same as just described. In the absence of MFN-based wheat tariff reductions in SACU, South African millers would continue to enjoy effective protection at a rate of about 100 percent against non-SADC imports (see last column of Table 5).

- *The situation would be quite different with respect to imports from the rest of SADC.* Suppose that some SADC millers were able to import wheat at world prices, there were no natural protection provided by transportation and other barriers, and they were able to mill wheat according to world standards (in terms of quality and cost). Under these conditions, they would be able to take advantage of intra-SADC free trade in flour and sell at a price as low as that prevailing in world markets. Against such competitors, South African millers would receive no tariff protection on wheat flour and might have to match the world price of flour to be able to compete. And, depending on local market conditions for wheat, they might have to do so with the disadvantage of higher cost domestic wheat.

  Table 6 shows the effective rate of protection to domestic millers in South Africa *vis à vis* SADC competitors under a liberal rule of origin and under the same range of assumptions about world wheat prices and the degree to which wheat import duties are passed on to South African millers. With no tariff protection on imports from SADC, South African millers face only the negative effects of their own country's import tariff on wheat. Unless none of the cost-raising impact of these tariffs is passed on to the millers (final column of Table 6), South African millers are seen to face *negative* effective protection.

Table 6
Effective Protection *vis à vis* SADC Competition
With SADC Free Trade and a Liberal Rule of Origin (%)

World Wheat Price	% of Wheat Tariff Borne by Millers			
	100%	70%	40%	0%
$125/ton	-61	-43	-25	0
$130/ton	-52	-36	-21	0
$135/ton	-42	-29	-17	0

If they have to absorb the full brunt of import tariffs on wheat (first column of Table 6) the effective rate of protection they face *vis à vis* SADC competitors is in the range of minus 42 to minus 61 percent. They would have to be able to produce at 42 to 61 percent lower cost than SADC competitors in order to sell in their domestic market. This is in stark contrast to the situation shown in Table 5, showing the effective protection faced under a restrictive rule of origin or in the absence of SADC free trade in flour.[14]

However if, as appears to be the case currently, none of the cost-raising impact of wheat tariffs were passed on to them, *South African millers, would have zero effective protection against SADC competitors (final column of Table 6). SADC free trade would place South African millers on a level playing field against SADC competition, even under a liberal rule of origin.* MFN import duties would continue to provide effective protection against non-SADC competitors at the high rates shown in the final column of Table 4.

4.1.3 Likely Impacts of a Liberal Rule on South African Flour Millers

How might the consequences of a liberal rule of origin translate into actual competition for South African millers in their local market?

The removal of tariffs on wheat flour may provide some SADC countries with an incentive to divert production to the South African market where flour prices might remain high due to the continued imposition of high MFN tariffs on flour imported into SACU. With access to wheat at world prices, they might have a cost advantage over South African millers (see first three columns of Table 6). In such circumstances they might even invest in new capacity to supply the South African market. This would be especially true if they expected South Africa to continue to protect its flour market against non-SADC competition.

However, there are several factors that would limit the ultimate harm to South African millers of any such production shifts.

- The capacities of non-South African milling industries are small, especially relative to the size of the South African market. South Africa accounts for almost 60 per cent of the milling capacity in SADC. SACU accounts for almost two-thirds of total. In

[14] It should be emphasized once again that this abstracts from the substantial amount of natural protection that would be afforded South African millers by transport costs and other logistical difficulties in exporting flour from other SADC countries to South Africa.

almost all non-South African countries, milling capacity is equal to or just a little bit more than the size of the domestic market.[15] South Africa, Tanzania and Zimbabwe are the three countries in which there is significant excess of milling capacity over domestic wheat flour demand.[16] Excess capacity in South Africa now stands at over 12 percent of the domestic market. As can be seen in Table 7, excess capacity in other SADC wheat flour markets is only a very small proportion of the South African market.

Table 7
Excess Flour Milling Capacity in SADC

Country	Domestic Requirements ('000 tons)	Milling Capacity ('000 tons)	% of SADC Cap.	Excess Capacity ('000 tons)	Excess Capacity (%)
Botswana	78	91	2	13	14
Lesotho	70	122	2	52	43
Malawi	60	60	1	0	0
Mauritius	103	180	3	77	43
Mozambique	180	288	6	108	38
Namibia	60	108	2	48	44
South Africa	2,500	3,000	58	500	17
Swaziland	40	50	1	10	20
Tanzania	250	560	11	310	55
Zambia	115	120	2	5	4
Zimbabwe	420	612	12	192	31
Total	3,876	5,191	100	1,315	25

Source: Figures based on information received during interviews and from SADC-FANR, National Chamber of Milling, Food Balance Sheet and SAGIS.

- The South African milling industry would remain well protected by both its greater scale and efficiency (at least for the sustainable larger and more modern mills that make up the largest, most modern and economically most important part of the industry) and by the natural barriers presented by the cost of shipping flour from other parts of SADC to the South African market.

- Any diversion of SADC production to the South African market would create an opportunity for South African firms to increase their exports to these SADC markets (in the absence of other barriers to such exports). They could make use of the duty rebate facility which allows them to match the world parity price when they use imported wheat. South Africa imports significant amounts wheat (accounting for well over 50 per cent of the SADC market demand excluding South Africa).[17] The incentive for South African firms to export would be increased if the non-SACU countries continued to maintain a high MFN tariffs on wheat flour.

[15] Malawi is the only country in which capacity is smaller than local demand.
[16] This reflects in part an incomplete adjustment to deregulation of the local market and to technical and other changes that have left the countries with a large number of small and very inefficient flour mills. These smaller mills are bound to exit the industry over time as a result of competition from larger, more efficient mills.
[17] Technically such production would not qualify under Option 1 since the rebate is only applicable to wheat that is imported and therefore the flour would not meet the rule of origin. But it would not be a problem under a liberal rule such as that being examined here.

- In the unlikely event that South African millers did suffer from a cost disadvantage and there were a substantial flood of SADC-sourced flour imports into the South African market, South African millers would not be able to pay protection-induced high prices for domestic flour. Since the domestic milling industry is the main market for local wheat, there would be downward pressure on local wheat prices. Competitive pressure in the flour market would drive down local wheat prices to a level at which South African millers would be able to compete. While South African millers would certainly lose some of the rents from the high levels of effective protection under current arrangements, a major part of any necessary adjustment would be borne by reductions in the local price of wheat. To the extent that local wheat growers already receive less than the landed price of comparable imports, this adjustment would once again have little effect on grain growers, and the principal effect would be an erosion of rents currently received by local millers.

Overall it is highly doubtful that the South African wheat milling industry will face a serious threat of "disruptive" competition under intra-SADC free trade, even with the liberal Option 2 rule of origin. There would be a substantial erosion of rents being provided by the current, highly protective tariff structure, and possibly an incentive to improve efficiency in some mills. Any such reductions in excess profits would yield corresponding benefits to South African consumers of flour and flour products as a result of the competing away of some of the protective impacts of high duties on the import of wheat flour. South African grain growers would be affected to only a very minimal extent, if at all.

As will be seen below, the same types of impacts of SADC free trade – erosion of millers' rents and corresponding benefits to consumers – would be expected in a number of other SADC Member States as a result of SADC free trade in wheat flour with a liberal rule of origin.

4.1.4 Competitiveness of South African Millers Outside South Africa

If domestic protection of wheat in South Africa caused a significant increase in the local price of wheat, it would be impossible for South African millers to compete outside of the local market, even with intra-SADC free trade in flour. Access to internationally priced wheat would give most non South African producers a cost advantage over South African millers in their local markets.

In these circumstances, South African producers would face negative effective protection due to the cost-raising effect of the high import tariff on wheat, exactly as shown earlier in Table 6. This, of course, abstracts from the additional disadvantage that would be faced in overcoming the transport and other logistical difficulties in delivering flour to these external markets.

Despite this, and even in the absence of intra-SADC free trade in flour, South African exporters are able to compete in regional markets. There are two reasons for this.

First, the South African duty rebate program provides compensation for the cost-raising impact of import duties on flour. Of course, the rebate applies only on the imported wheat

content of the exported wheat flour – the exporter receives a rebate of the duty paid on the actual wheat imports, but not on any high priced domestic wheat that is used.[18]

Second, as already indicated, South African domestic wheat prices do not appear to be very strongly affected by the import duty on wheat.

If flour exports benefit from a full duty rebate on all wheat used, and if the (liberal) Option 2 rule of origin were adopted, South African exporters would be on a level playing field in an external SADC market *vis à vis* any other SADC competitors (final column of Table 6). Furthermore, if the SADC export market were protected by an MFN import duty, South African exporters would have a cost advantage over non-SADC exporters in that market.

Under the rebate programme (and on an MFN basis with no applicable rule of origin) an exporter could use all imported wheat and be compensated in full for the cost-raising effects of protection of wheat in the South African market. To the extent that domestic wheat in South Africa is priced at less than the world price plus tariff, the competitiveness of South African millers in external markets is enhanced further.

This analysis of SADC free trade has been based on the assumption that South Africa's SADC partners actually implement free trade in wheat flour. There are two serious problems here.

First, under the differential tariff phase down schedules, South Africa is scheduled to reduce its flour import duties much more quickly than other Members. As in many other sectors, most non-SACU members' tariff reductions are heavily back-loaded. Therefore, even in the absence of other restrictions, South African millers will not have preferential access to most other SADC markets for many years, despite the opening of their own market to SADC competition at a relatively rapid pace.

Second, as indicated earlier, a number of Member States have erected significant non-tariff barriers against flour imports. These barriers are an additional constraint for South African millers to overcome in order to compete in other SADC markets.

It needs to be emphasized, therefore, that this analysis of South Africa's competitive position in other SADC markets applies only to the point after which tariff and non-tariff barriers are fully removed, so that SADC free trade is a reality.

It is for this reason that it is important to analyze the structure of protection and resulting incentives created in other SADC markets.

4.2 Wheat Flour Markets in the Rest of SADC

All countries are net importers of wheat; only a few countries supply a significant share of their domestic markets with local wheat. Except for Mauritius wheat is not the principal grain

[18] The nature of the milling process of course makes it very difficult to trace the links between any particular bag or container of flour and the actual wheat that was used to produce it. To get full compensation for the cost-raising impact of import duties on wheat, all a miller would have to do is ensure that enough imported wheat was used over the relevant time period to cover the input needs of any exports – regardless of whether the imported wheat was actually used in the exported flour.

in the "common diet" in most countries; but it has an income elasticity of more than one, which implies that wheat deficits will grow over time.

The MFN duty rates on wheat and flour in SADC Member States were shown in Table 2 earlier. In most cases, import duty rates on flour exceed those on wheat, implying that flour milling receives substantial effective protection. It is only in Malawi and Mauritius that no protection is given against flour imports (and no tariffs levied on wheat either). Tanzania levies import duties of 30 percent on both wheat and flour. In addition, as described earlier (section 3) a number of Member States impose NTBs that further reduce import competition facing local millers.

Effective rates of protection to flour milling in each of the non-RSA SADC markets under the current MFN duty structures are shown in the first column of Table 8. Effective protection to South African millers is included for purpose of comparison. It should be noted that these estimates do not include the protective effect of NTBs or, as was true of the earlier estimates for South Africa, the natural protection provided by transport costs.

Table 8
Effective Protection to SADC Flour Millers
***vis à vis* SADC competition, due to Current MFN Tariffs (%)**

Country	Current	With SADC Free Trade, Liberal Rule
BLNS	99	0
Malawi	0	0
Mauritius	0	0
Mozambique	98	-6
South Africa (a)	99	0
South Africa (b)	75	0
Tanzania	25	-62
Zambia	75	-12
Zimbabwe	127	-12

Note: 'South Africa (a)' shows the effective rate of protection that would prevail if tariffs had been adjusted continuously to changes in world wheat prices according to the South African tariff formula. In fact, there is some stickiness built in to the adjustment mechanism. As a result of the relative stability of world wheat prices over the past year or more, the Rand value of the tariffs has not changed in some time. Meanwhile the depreciation of the Rand has eroded the real (US dollar) value of this tariff. 'South Africa (b)' shows the effects of actual tariffs in effect in February 2002.

The table shows a wide range of effective protection rates; but the Members can be broken down into essentially two groups. Most Members – the BLNS countries, Mozambique, South Africa, Zambia and Zimbabwe – provide substantial protection to their domestic millers, at rates in excess of 75 percent (98 percent and higher for all except Zambia) Zimbabwe, with effective protection of 127 percent, provides substantially higher levels of protection than South Africa. The others – Malawi, Mauritius and Tanzania – give much less protection (effective protection of 0 percent in the case of the first two, and 30 percent for the latter).

Except for Malawi and Mauritius, therefore, all Member States provide very high levels of effective protection to their local milling industries. With these structures of protection,

millers can be tolerate very high levels of inefficiency and/or benefit from substantial economic rents, and still able to compete against imports from anywhere in SADC or elsewhere. For seven of the eleven countries shown in Table 8, local millers can tolerate processing margins 99 percent of more in excess of those that are the standard in international markets. As was observed in the case of South Africa, the biggest losers from this protection are domestic consumers of flour and flour products, of which bread is by far the most important.

The effect of SADC free trade in these Member States will depend critically on the choice of a rule of origin. With a restrictive rule such as that proposed in Option 1, SADC free trade in flour would have very little impact, since most producers would not have access to the regional wheat that would have to be used in order to qualify for SADC tariff preferences. Under such a rule of origin, the effective rates of protection in domestic markets would remain more or less as shown in the first column of Table 8.

The only exception would be with respect to competition from South Africa and possibly some of the other BLNS countries whose millers are able to obtain wheat locally at import parity prices. Such millers would have an advantage over other exporters in SADC markets. Once the SADC tariff phase-downs are complete and assuming no other NTBs bar their access to SADC markets, these South African and BLNS millers would be able to compete on a level playing field versus local competitors, even with a restrictive rule of origin

However, other SADC producers without access to locally grown wheat would gain no preferential access to SADC markets under such a rule of origin, and SADC free trade would not permit them to compete in any market with significant MFN tariff protection on flour imports. Under current MFN tariff rates, the only markets in which they would be able to compete would be Malawi and Mauritius, markets to which they already have access without SADC preferences.

On the other hand, with a liberal rule of origin such as Option 2, millers in all Member States would be able to use imported wheat when producing for sale under SADC preferences. The effective rates of protection facing domestic millers in each of the SADC Member States in these circumstances (SADC free trade and liberal rule of origin) are shown in the final column of Table 8. The estimates show that, with the exception of millers in Tanzania and to a much smaller extent in Zambia and Zimbabwe, SADC free trade would put all millers on a level playing field, with zero effective protection against other SADC competitors. Millers in Tanzania would face large negative protection against such competition due to its high rate of import duty on flour. On the other hand, they probably benefit from higher levels of natural protection due to the cost of transporting flour from other parts of SADC.

All of this is contingent on the removal of other barriers to intra-SADC trade. In particular, these results will not occur in any market until its SADC tariff phase-down is complete and restrictive NTBs are removed.

Under current MFN import duties, of course, protection against non-SADC competition would remain as shown in the first column of Table 8.[19]

[19] In fact, the effective protection against non-SADC competition would be significantly higher (by at least 20 percentage points) than shown in the first column of Table 8 as a result of the natural protection provided by transport costs on wheat and flour.

5. Conclusions and Policy Recommendations for Wheat Flour

There are several proposed rules of origin under consideration for wheat flour. In deciding among these or other alternatives, the main issue is whether use of locally or regionally grown wheat should be required for flour to qualify for SADC preferences.

Discussion of rules of origin and related preferential arrangements in this sector has been diverted by questions about the need to protect local grain growers against unfair, subsidized international competition, about the implications of such protection for downstream millers, and by questions about wheat growing capacities in SADC, including whether SADC is or could be self-sufficient in wheat.

Insufficient attention has been paid to the actual operation of wheat and flour markets in the Member States. A closer examination of these markets produces some interesting insights and yields some simple conclusions about the implications of alternative rules of origin.

The most important fact in understanding resistance to liberalization of SADC trade in flour is that almost all Member States provide very high levels of protection to their local milling industries. With the exception of Malawi, Mauritius and to a lesser extent Tanzania, current MFN tariffs provide high levels of effective protection – 75 to 127 percent – to domestic wheat millers. In all but one of these the rate of effective rate of protection is 98 percent or higher. This means that local millers can have processing costs that are at least double those in normal international flour mills and still compete against imports.

If these mills are able to reach normal efficiency levels, as many are able to do, these margins translate into enormous economic rents, or excess profits.

A number of Member States provide significant additional protection through non-tariff import barriers (NTBs). The most important of these are import licensing schemes that impose local purchase requirements as a condition to import flour.

The burden of this protection of local milling industries falls primarily on domestic consumers of flour products, especially bread. For SADC exporters of downstream products such as biscuits, protection of flour is a barrier to their international competitiveness.

The main impact of a restrictive rule of origin will be to eliminate the emergence of intra-SADC competition that might erode the protection currently afforded SADC flour millers – that is, such rules would preserve the current levels of protection enjoyed by SADC milling industries.

A principal rationale for continued protection of flour milling industries and hence for a restrictive rule of origin in SADC is to compensate millers for the alleged cost-raising effects of policies designed to protect domestic wheat growers. Protection of local wheat growers is justified, in turn, on the basis of distortions in international grain markets arising from protection and export subsidies by major international wheat producers.

In fact, protection of milling is far more than sufficient to compensate for any possible cost-raising effect of protecting grain growers.

Furthermore, there is considerable evidence that local wheat in South Africa is priced more or less at import parity (before import duties). In other words, protection of wheat does not help local wheat growers and imposes no cost penalty on millers, at least in respect of domestic wheat, which accounts for the majority of their wheat purchases.[20]

The rhetoric about the need to protect local wheat growers and the debates about whether SADC might ever be self-sufficient in wheat have diverted attention from the principal issue – an attempt to use restrictive rules of origin to preserve protected markets for wheat flour.

All Member States are net wheat importers and only a few produce significant amounts of wheat. The economic rationale for high levels of protection for millers in non-wheat-producing Member States is even less apparent.

If flour and its products are considered to be 'strategic' products or are felt to be essential for food security and/or poverty reduction, high levels of protection that serve only to increase local prices are not the solution. Flour is readily available at highly competitive prices in world markets. Furthermore, experience internationally and in SADC itself shows that local and international investors are able to develop local milling capacity and supply at competitive prices as long as they are not hindered by artificially high raw material prices and other regulatory restrictions. Special incentives and high levels of protection are not necessary.[21] But competitive market conditions are essential.

5.1 Recommended Rule of Origin

Wheat milling is a substantive economic activity, regardless of the source of the wheat. It is not a 'screwdriver' operation. It requires large investments in milling and packaging equipment, testing facilities, and buildings. It employs substantial numbers of workers in logistics, production and packaging. Flour milling is not a simple 'screwdriver' assembly operation that should be excluded from SADC tariff preferences for reasons envisaged in Rule 3 of Annex I on Rules of Origin of the Trade Protocol.[22]

A simple rule of origin requiring a single change of tariff heading (from wheat to flour) is all that is necessary to authenticate that flour originates in the region, that it results from substantial economic activity in the region and that it should qualify for SADC trade preferences.

[20] In addition, when competing in regional and other export markets South African millers are insulated from the cost-raising effects of duties on imported wheat by a duty rebate program. South African millers currently export to a number of SADC markets.

[21] Evidence from the same sources also shows that investors and associated vested interests will not be reluctant to accept special incentives and to reap large profits, at the expense of local consumers and tax payers. It is up to governments to decide on the kind of regulatory environment they wish to foster.

[22] Rule 3 provides a blanket disqualification from SADC trade preferences for goods that have been imported from non-members and have undergone only minor transformations such as labeling, packaging, simple mixing and assembly in SADC.

To determine whether flour milling is actually taking place in any mill and how much is actually being milled is not difficult, thus making this an easy rule to enforce. A more restrictive rule of origin – one requiring the use of regional wheat – is not required to authenticate that flour used in intra-SADC trade is the result of substantive economic activity.

5.2 Related Implementation Issues

Some millers, especially in South Africa, are concerned about inequities arising from the slow pace of tariff reductions and the existence of NTBs on wheat flour imports in other Member States. This is a legitimate concern.

There is no justification for a slower pace of liberalization of imports of flour in some states than in others. Flour milling does not suffer any particular disadvantages that would justify a slower pace of liberalization in some countries than in others – whether on the basis of per capita income, country size or any other indicator of economic development.

However, a restrictive rule of origin is not the answer. This would be an indirect and costly way of undoing the beneficial effects of tariff liberalization. The appropriate approach is for all members to agree to open their markets at the same pace. Slower Members should speed up the pace of tariff reduction and eliminate NTBs on flour imports immediately.

If some members insist on delaying the opening of their domestic markets, others might wish to reduce their own pace of tariff liberalization accordingly. This should be done directly and not through the 'back door' by introducing restrictive rules of origin.

Finally, if any Member State is simply unwilling to expose its millers to SADC competition, for whatever reason, the solution is for the Member to exclude this sector from its trade liberalization offer – not to insist on restrictive rule of origin that would disrupt trade among other Members that do wish to open their borders. Excluding flour would permit a Member State to continue to protect its flour millers from SADC competition, but it would also disqualify its millers from SADC tariff preferences in other markets.

6. Products of Wheat Flour

Unlike flour, products such as pasta and biscuits are at least in part 'two steps removed' in the production chain from the original agricultural raw material – they are products of agricultural products rather than of the raw materials themselves. Nevertheless, some parties have proposed restrictive rules of origin based on requirements to use local raw materials whenever they might be available.

The case for restrictive rules of origin for products one step removed from the raw materials (e.g. wheat) is very weak. Processors prefer to use local raw materials when they are competitively supplied, in terms of price, quality and product description. When these competitive conditions are met, a restrictive rule is not required – producers will source locally out of their own self-interest. If the conditions are not met, restrictive sourcing requirements will reduce the competitiveness of regional processors. Not only will this raise consumer prices and harm the development of the processors, but it will also remove a source of demand for local raw materials – a lose-lose situation for all concerned.

In the case of processing that is further downstream – more than one step removed from the agricultural raw material – the case for simple and even non-restrictive rules of origin is similar, but even stronger.

Good quality pasta requires durum wheat – a type that is simply 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. While this makes it technically possible to produce 'European' type pasta, it is of higher cost and lower quality. As one SADC supplier described it, the resulting pasta is excessively brittle, with the result that a significant portion of the final product crumbles to powder before the consumer ever opens the package.[23] This particular producer, who has ceased all local pasta production, claims that all local pasta producers use imported flour, despite high import duties.[24]

Requiring the use of flour milled from local wheat in order for pasta to qualify for SADC preferences will make the Trade Protocol irrelevant in yet another market. 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. Such a restrictive rule of origin would simply preserve the protected markets and the resulting excess profits from the threat of competition from regional suppliers operating under the Trade Protocol. 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.

If some Member States wish to exclude particular downstream flour products from SADC preferential trade, they should do so directly, by excluding these products from their liberalization offers. It should be understood that this would prevent their producers from taking advantage of SADC preferences under the Protocol. This is a reasonable price to pay for not participating in SADC trade arrangements in these sectors. But a restrictive rule of origin that would hinder all SADC trade is an inappropriate way to deal with the protectionist proclivities of particular members.

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 wheat milled from flour 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, which would make the products almost impossible to market in developed country markets.

To make SADC relevant for internationally competitive producers will require simple and non-restrictive rules of origin. Restrictive rules of origin will reduce their competitiveness and be of no benefit to upstream suppliers. The only possible 'benefit' might be to eliminate

[23] The recently completed pasta plant in Namibia employs a high temperature technology that overcomes some of the technical problems related to brittleness of product using local wheat.
[24] In the case of South African pasta exports, the effect of high import duties on flour is largely offset by use of the government's duty rebate facility for exporters.

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 much larger investments and numbers of jobs that will arise from the development of internationally competitive producers in the SADC region.

A rule of origin requiring a simple change of tariff heading is all that is necessary for these products. A more stringent requirement that products be made with flour milled from regionally grown wheat would make the SADC Trade Protocol irrelevant for this sector, despite the international export competitiveness of a number of regional producers.

As a practical matter, most flour made from imported wheat that is used in these sectors is actually milled in the region. Therefore a double transformation requirement – that wheat used in these products be milled in the region (but not necessarily from domestic wheat) – would not be a serious impediment and therefore would be the recommended alternative at the moment.

Reduction of tariffs and other import barriers should proceed at the same pace in all Member States. There is no economic rationale for infant industry protection of these products through any means. Restrictive rules of origin certainly should not be used for this purpose or as a means of delaying SADC trade liberalization on account of such practices in some Member States. Members that wish to continue to protect their domestic markets for any of these goods should exclude the sector from their liberalization offer.