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Technical Report:

SADC Trade Audit: Rules of Origin

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ACRONYMS

BLNS	Botswana, Lesotho, Namibia and Swaziland
COMESA	Common Market for Eastern and Southern Africa
EAC	East African Community
EPA	Economic Partnership Agreement
EU	European Union
FTA	Free Trade Agreement
HS	Harmonized System
LDC	Less Developed Country
NTB	Non-Tariff Barrier
PTA	Preferential Trading Agreement
SACU	Southern Africa Customs Union
SADC	Southern African Development Community
U.S.	United States of America

EXECUTIVE SUMMARY

Negotiation of SADC rules of origin has been a long and unfortunately circuitous process. It began with quite a simple concept and a correspondingly elegant and appropriate solution. The underlying goal was to promote intra-SADC trade by eliminating import duties and other unnecessary restrictions. In order to accomplish this, it was necessary to define rules of origin that could be used to certify that goods claiming to be eligible for SADC tariff preferences actually originated in a Member State.

The solution was some general and very simple rules that defined a minimum level of processing or manufacturing activity necessary for this purpose, and that set out certain conditions or activities (labeling, packaging, etc.) that were not sufficient. The initially agreed rules for non-primary products set out three quite reasonable conditions, satisfaction of any one of which would suffice to confer originating status regardless of the good under consideration. For agricultural and other primary products, the condition was simply that the good be wholly obtained in a Member State.

Seeing the wisdom and practicality of SADC's decisions, COMESA adopted the same rules.

Before the Trade Protocol came into effect, however, a new dynamic took over, setting in motion a process in which the SADC rules were renegotiated on a sector-by-sector and product-by-product basis. The process was captured by special interests or their representatives in a number of Member States that felt they might be threatened by freer trade in the region. Rather than basing the discussions on the goal of increasing intra-SADC trade, the goal became one of using the rules to minimize "harmful competition" that might arise from regional free trade.

With a few key exceptions, a set of rules was eventually agreed. However, as was pointed out in the Mid-Term Review of the Trade Protocol, many of the rules were unnecessarily restrictive and undermined the intention of the Protocol to promote intra-SADC trade. Furthermore, they often worked against even the special interests they were intended to support.

Since that time a slow but steady process has succeeded in rectifying many of the problems identified in the Mid-Term Review. For most manufactured goods, the rules are now relatively unrestrictive, and they are unlikely to be a hindrance to intra-SADC trade. There are still remnants of the protectionist approach that guided prior negotiations. For instance, conditions on maximum imported content vary unnecessarily across similar goods in the same tariff heading. There remain a few process conditions that in some cases simply add clarity and certainty, but in others once again reflect a misplaced desire to use the rules of origin to promote a particular industrial policy goal. But few of these conditions are a significant barrier to intra-SADC trade.

By and large most SADC rules of origin are now no more restrictive than those in COMESA or in the EPA deals agreed with the EU. Since the Mid-Term Review, for instance, the rules for HS chapters 84 and 85 have been significantly improved. In chapters 26 to 38, the choice of conditions available makes them less restrictive than

COMESA's.

There remain a few problems in processed foods sectors (blended teas, coffee and mixtures of spices), where local content requirements are likely to continue to restrict trade and which actually fail to assist the primary product sectors they are intended to help. These should be cleaned up by agreeing to a rule that requires "manufacture from materials of any tariff heading" which is consistent with the EPA rules of origin.[1]

But the biggest problems remain

- wheat flour, where a rule has yet to be agreed, and
- garments and textiles, where the yarn-forward rule for garments remains an unnecessary and for many countries (including some of those that insist on keeping it) costly impediment to intra-SADC trade.

For wheat flour, the only sensible rule of origin is single transformation, or change of tariff heading, with no restrictions on sourcing of wheat. Apparently South Africa, one of the initial and strongest opponents of this rule, has now agreed to it, and only a small number of other Member States are holding out. If these Members are unwilling to allow intra-SADC free trade under these conditions, they should not continue to block other countries from doing so. They could protect their own millers, if they wish, by declaring this to be a sensitive sector and preventing preferential access to their markets by other Member States by postponing agreed tariff reductions.[2]

The only sensible rule for garments is also single transformation. Unfortunately a number of Member States, especially South Africa, are intent on using high levels of tariff protection to shelter their garment industries from external competition and to insulate them from the cost-raising impacts of protection of their textile industries. Through their membership in SACU, producers in several of the BLNS countries also benefit from this arrangement. In these circumstances the purpose of a restrictive rule of origin for garments is to insulate the South African market from regional competition that might arise from SADC free trade.

This problem will continue as long as SACU continues its current tariff policy aimed at protecting its vulnerable garment industry.

Are there any solutions, other than liberalization of SACU's MFN tariff policies, in this sector?

Solution 1: As suggested above in the case of wheat flour, one solution might be to agree to a single transformation rule for garments, but for SACU to exclude this and maybe the textile industry from its preferential tariff offers. This would allow other Member States to trade under the single transformation rule. However, South Africa is by far the largest market for garments in SADC, and excluding this market from

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[1] A change of tariff heading rule would not suffice since the inputs and outputs are classified in the same tariff heading.

[2] Or they could do as a number of other Member States have done by restricting imports of wheat flour through bans, licensing requirements or other quantitative restrictions. While such measures are contrary to the law and spirit of the Trade Protocol are widely used in the agricultural sector and are a far bigger threat than rules of origin to SADC trade integration.

SADC preferences would remove most of the value of liberalizing trade in garments in SADC. It would not provide a market size that would be anywhere close to large enough to take advantage of competitiveness-enhancing scale economies. A SADC free trade arrangement that excludes the South African market would be of little economic value.

Solution 2: The other possibility would be to agree on a single transformation rule for garments, and for SACU to permit duty-free access to its markets by garment producers in all or at least some SADC Member States, but on a quota-restricted basis. This is similar to the arrangement that was made to allow some of the poorer Member States temporary access to the SACU market under a single transformation rule during the initial period of implementation of the Trade Protocol (the so-called MMTZ rule). Imposing quota restrictions would protect SACU producers from the unlikely possibility of a sudden large surge of competitive imports from SADC.

Neither of these solutions is particularly attractive. But either one would at least get over the hurdle of defining a sensible rule of origin for this sector, and would permit discussion to focus on the real issue of the appropriate trade and industrial policy for this sector

The few remaining problems with SADC rules of origin should be resolved in order to complete this part of implementation of the Trade Protocol. But aside from these few problems, rules of origin are no longer a major impediment to free trade in SADC and beyond. The bigger issues now arise from the approach and its underlying assumptions that led to the domination of rules of origin negotiations by special interests that saw the freeing of trade as a threat to rather than an essential part of a strategy for successful integration into global value chains. The fallout from this approach can be seen in the proliferation of many different kinds of barriers to intra-regional trade that are documented in other parts of the Trade Audit.

The few remaining problems with rules of origin will also need to be resolved in order to engage in meaningful discussions of rules of origin for an expanded Tri-Partite Free Trade Area joining SADC with COMESA and the EAC. In all of the “problem” areas just discussed above, the simple solution will be to adopt a single transformation or change of tariff heading rule, or in cases where inputs and outputs fall under the same tariff heading, an appropriate value addition or local content requirement. This would make SADC rules consistent with those in the COMESA and the EAC. This solution is also consistent, of course, with the SADC goal of promoting trade among its own Member States.

Some observers feel that major differences in rules of origin will pose the greatest difficulty in coming to an agreement on a Tri-Partite FTA. The biggest obstacle in this regard will be the difference between SADC’s list rules and the general non-sector-specific rules in COMESA.

However, negotiators should not confuse this with the existence of serious substantive differences in the restrictiveness of SADC and COMESA rules. As observed above, the amendments following the Mid-Term Review have resulted in rules that, with the few exceptions identified earlier, are good for SADC and compare relatively favorably with those in COMESA and elsewhere. Precise comparisons are made difficult by differences in measuring value (factory cost versus market price)

and by a variety of product-specific process requirements.[3]

What is to be avoided if at all possible is a repetition of the SADC experience of (re)negotiating rules on a product-by-product basis based primarily on inputs from special interests reluctant to face increased regional or international competition in their local markets. To avoid this it would be wise to sequence negotiations in such a way that rules of origin are determined before agreement is reached on tariff reduction schedules and even on the principle of duty-free, quota-free trade across all tariff lines. This would allow Member States to protect "sensitive" sectors by delaying or excluding liberalization in such sectors without having to resort to rules of origin that would prevent preferential trade among all other Member States as well.

SADC, COMESA and EAC rules are no longer significantly different in their substantive requirements. It should be possible to bring them into harmony without endangering the more general and important goal of expanding trade in the region and global competitiveness of regional producers through enhancing and reducing barriers to intra-regional trade. Rules of origin are no longer and should not be allowed to become again a major obstacle to achieving this goal. This way attention can be focused on the more important impediments to regional integration in SADC and beyond.

[3] The original SADC and current COMESA rules were/are both based on factory cost. EU rules are based on factory price. The U.S. uses both, allowing for a "built-up" or "built down" method of calculation, with the difference between the two calculations generally in the range of 10 percent—e.g. 35 versus 45 percent value added. In the SADC rules, 60 percent imported content requirements are based on factory price (and therefore 40 percent local content requirements on factory price). The factory price method is less demanding administratively since it does not require Customs to do reviews of cost structures.

1. INTRODUCTION

When countries agree to allow duty-free (or reduced-duty) imports from each other, it is necessary to verify that shipments claiming the resulting preferential treatment actually originate in one of the partner countries. This requires the definition and enforcement of rules of origin. Rules of origin are critical to any preferential trading arrangement, especially when there are significant differences in members' non-preferential tariff structures. This is because differences in external duty rates create incentives for "trade deflection"—reductions in or even avoidance of import duty obligations by shipping non-member country goods into a high-duty partner via a member country with lower external duty rates.

2. THE CONCEPT OF ORIGIN: GENERAL PRINCIPLES

For primary products such as minerals and agricultural produce the concept of origin is straightforward. If the product was extracted or grown in a member country, it can be considered to have originated there; if it was extracted or grown in a non-member country, it cannot be considered to originate within the free trade area.

For processed and manufactured goods, however, the concept of origin is not quite so obvious. Huge improvements in efficiency and resulting reductions in the cost of logistics and communications have resulted in a virtual revolution in global production in recent decades. Global manufacturing is now parceled out around the world in complex and ever-changing patterns. An Apple iPhone that is assembled in some factory in China, for instance, comprises components that have been made in all parts of the world. Many of these components are made from sub-components with similarly diverse origins. Furthermore, a large share of the value of such products arises from and accrues to design and marketing efforts that take place in yet different locations.

The same is true of more humble products such as garments, shoes and even blended teas ("English" breakfast tea), coffees ("Italian" coffee), spices ("Indian" curry) and other food delicacies ("Swiss" chocolate).

For a large and growing share of goods traded internationally it is impossible to identify them as "originating" in any particular country. Furthermore, the geographic sourcing patterns involved in the production of any final good are constantly evolving in response to changing relative costs, fashions and risk management strategies of buyers and sellers.

A definition of origin for the purposes of implementing an FTA (Free Trade Agreement) should conform to the economic realities of global value chains as they operate today and should be consistent with and if possible encourage the kind of participation in these value chains that promotes the long-term economic development of member countries. Regional economic integration works best if it encourages and eases the integration of members in the global economy, and in particular if it facilitates their competitive participation in international production networks.

In other words, a good sourced from an FTA partner country should be considered to

have originated in that country if it is the product of an activity there that would form a legitimate part of a global production network.

There are two kinds of risks to be considered in making this concept operational in a definition of origin.

- If a rule of origin is too "lax," there is the risk of trade diversion—goods produced elsewhere will be imported into a member country with low import duty rates and transshipped to a member country with higher duty rates on those goods. This reduces the effectiveness of the final destination country's higher import duties on third country imports. This magnitude of this risk increases with the size of differences in external duty rates among member countries and with the ease of transshipping goods through the low duty country.
- If a rule of origin is too demanding, or restrictive, there is a risk that it will discourage or even prevent investors from taking advantage of opportunities to insert themselves into global production networks.

There are legitimate differences of opinion on the relative importance of these two types of risk. Members that rely on high external import duties as an instrument of industrial policy will, of course, tend to place greater emphasis on the first risk. However, as FTA members begin to harmonize external tariff structures in preparation for deeper forms of regional integration, and/or as external trade barriers fall over time as a result of global, preferential and unilateral trade liberalization, this concern will certainly diminish. In the case of SADC and other "south-south" FTAs, trade agreements and preferential arrangements with the EU and the US are important in the latter regard.

There is also a view that restrictive rules of origin can be used as an instrument to promote the development of local and regional value chains. This is based on an old idea that the key to longer-term economic development was the development of national value chains in key industries, starting with basic industrial products such as steel and plastic raw materials, and continuing through intermediate inputs to final goods. Whatever merit this view might have had in the past, it is certainly no longer true in today's world of closely linked global value chains. The key to participating effectively and competitively in this world is to create a business environment in which a country can attract investors into any part of any value chain. This requires, not local availability of complementary parts of upstream and/or downstream value chains, but rather, among other things, efficient logistics and border regulations that make it easy and inexpensive to import and export and thus enjoy high levels of connectivity with global production networks.[4]

This is not to say that development of local or regional parts of related value chains will not or should not happen. But the development of local and regional value chains is something that should be market driven rather than a government requirement set out as a condition for doing business. Government-imposed local or regional content

[4] This is especially true in SADC where relative market sizes, even including South Africa, are tiny relative to the global markets in which internationally competitive producers succeed by taking advantage of the economies of scale made possible by the size of these markets. A strategy of developing complete industrial value chains based solely on the SADC market would have a very low chance of competitive success in global markets.

rules raise costs and thus reduce competitiveness and hinder a country's ability to latch on to and participate beneficially in global production networks. Restrictive rules of origin that impose unreasonable local or regional content requirements as a condition for benefitting from trade preferences are an example of such counter-productive measures.[5]

3. RULES OF ORIGIN: A SIMPLE ANATOMY

Rules of origin generally are of two types. Most rules of origin regimes include rules of both types.

- The first kind of rule stipulates certain types of goods and activities that do not qualify a good to be considered as originating in a country. Thus simple packaging or labeling of a good, for instance, is generally deemed to be insufficient on its own to confer origin.
- The second kind of rule specifies conditions that are necessary for a good to be considered to originate in the FTA. These conditions are generally ways of confirming that a certain minimum amount of manufacturing or processing activity actually took place in an FTA member country; they can be of many different forms. Among the most frequently used are those that specify a maximum amount of content in the good that is permitted to be imported from outside the FTA, or a minimum amount of content or value added that must be sourced or produced in a member country. In addition, the rules might specify certain technical requirements in the processing or manufacture of the good that need to be met. These could involve engineering or process requirements (e.g. a printed circuit board needs to be "populated" in a member country) or they could describe necessary differences between the main inputs and outputs. The latter is often done by making use of the HS tariff code descriptions—requiring that a good undergo a "change of tariff heading" in the process of its production in a member county; i.e. the output of the manufacturing process must belong to a different tariff heading than the inputs. Despite the fact that the HS tariff codes were constructed for a very different purpose, and certainly were not designed on the basis of any kind of engineering criteria, this kind of rule turns out to be reasonable for a surprisingly large number of traded goods.

Rules of origin regimes are generally regarded as more or less restrictive according to how demanding the second set of rules are—i.e. according to how much local content or value-added is required or how little import content is permitted. While this is a pretty obvious point, it still is not always easy to make simple comparisons of the restrictiveness of different regimes or even of requirements for different products in a given regime. This is partly due to different ways of measuring values and costs (e.g. measuring the value of a product at factory price or factory cost, or measuring imports at c.i.f., fob or local market prices). And even with a common definition of these variables, differences in technologies and market conditions related to different products mean that any particular local content requirement might be much more restrictive for one product than for another. A change of tariff heading requirement might be very easy to meet for many products, but impossible to meet for others

[5] See Erasmus, Flatters and Kirk (2006) for further discussion, in the SADC context, of the issues covered in this and the previous paragraph.

when an important but technologically sophisticated input is classified in the same tariff heading as an output assembled from that input.

Rules of origin regimes differ not only in how they use these two kinds of rules to define origin, but also in the extent to which they specify the rules on a product-by-product basis or in a more general way. Some regimes define the rules on a highly disaggregated basis, applying distinct rules for each product or at least for relatively disaggregated groups of products. At the other extreme there are regimes that set out some very general rules that do not differentiate at all across products or groups of products.

There is an obvious temptation to think of the latter type of regime as simpler and/or more transparent than the former. But this is not necessarily the case, especially when specific product rules are provided primarily to increase certainty about the meaning of the requirements for these products. Furthermore, for the reasons mentioned a couple of paragraphs earlier, applying the same rules to all products almost certainly means that they are more restrictive for some goods than for others.

4. SADC RULES OF ORIGIN: A BRIEF INITIAL HISTORY

The initial rules of origin laid out in the SADC Trade Protocol were simple in concept and consistent with those in other developing country preferential trading arrangements, including most importantly neighboring and overlapping COMESA.[6] They included both general conditions stipulating that simple packaging, assembly and labeling, for instance, are insufficient to confer originating status (Rule 3 of Annex I to the Protocol), and specific rules setting out minimum levels of economic activity necessary to confer originating status. The specific rules provided several conditions, satisfaction of any single one of which qualify a manufactured good as originating in a Member State and qualifying for SADC tariff preferences:

- undergo a change of tariff heading, or
- contain a minimum of 35 percent regional value added, or
- include non-SADC imported materials worth no more than 60 percent of the value of total inputs used.

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

Before the Trade Protocol even came into effect, however, certain member states, led initially by South Africa, pressed for exceptions to these rules. As the only Member State with a significant manufacturing base, South African government had second thoughts about the possible dangers of regional competition that might emerge with liberalization of intra-SADC trade. After signaling its intent to promote regional free trade, therefore, South Africa then clarified that this was subject to the important constraint that it not endanger existing domestic industries. In particular,

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

for goods to benefit from SADC preferences, they must be 'genuinely produced in SADC.'

What this meant in practice was determined only after a protracted and often difficult set of negotiations in the process of which the SADC rules of origin became product-specific and generally more restrictive, in some cases considerably so. The change of tariff heading requirement was replaced by multiple transformation rules and/or detailed descriptions of required production processes. Value added requirements were raised, and permissible levels of import content were decreased. Most of the arguments for such rules boiled down to attempts to increase or preserve protection in domestic markets.

The rules of origin in the amended Trade Protocol thus were very different from what was originally agreed, and were characterized by made-to-measure, relatively restrictive product-specific requirements.

The rules came to be much more like those in the EU and in PTAs with rich, highly industrialized countries.[7] They were particularly similar to the rules in the EU-South Africa trade agreement (the TDCA or Trade and Development Cooperation Agreement that was signed in 1999). This is no coincidence. The EU-South Africa rules were often invoked by special interests, especially in South Africa, as models for SADC. Such claims were often accepted at face value and were not generally recognized as self-interested pleading for protection by already heavily protected domestic producers. There was little or no discussion about the appropriateness of such a regime for SADC. The TDCA was not even a free trade agreement, at least in the way this is normally understood. There was no attempt to achieve comprehensive quota-free, duty-free preferential trade. In most cases tariff liberalization was only partial, and many sensitive products were simply excluded, on both sides. This was not a suitable model for SADC.

Another factor explaining this evolution towards more restrictive rules of origin might have been the complex and asymmetric pattern of tariff phase down schedules agreed under the Trade Protocol. As part of the transition to intra-SADC free trade, the relatively less developed member states were permitted to phase down their tariff rates at a slower rate than South Africa/SACU.[8] Furthermore, in order to take account of the divergent levels of development between the SACU members the non-SACU countries were permitted to phase down preferential tariffs more slowly towards South Africa than towards the rest of SADC.[9]

It was only after the fact that many producer interests in South Africa began to complain about opening up their own market without immediate reciprocal liberalization in other Member State markets. The complexity of the compromises involved in the tariff phase downs made it difficult to reopen tariff negotiations to deal with this problem.[10] This placed the burden of dealing with any ex post complaints of

[7] Estevadeordal and Suominen (2006) refer to this as the PANEURO model.

[8] With a common external tariff, SACU presented one tariff phase down offer to the rest of SADC.

[9] As we shall see below, this transitional asymmetry was also carried over into rules of origin in the textile sector.

[10] South Africa's entry into other trade agreements, especially with the EU, together with its commitment in SADC never to offer better preferential access to its markets than to SADC producers added to the difficulty of slowing down or reversing agreed SADC tariff reductions.

excessively rapid liberalization on other instruments, most importantly rules of origin. Stakeholders wishing to forestall increases in competition arising from preferential tariff reductions found rules of origin to be a very useful tool. Restrictive rules of origin then became a permanent ‘solution’ to what was largely a transitional issue arising from different rates of tariff phase-downs on intra-SADC trade. Undue attention to relatively short term transitional tariff issues left SADC with what came to be seen as permanently flawed rules of origin.[11] In retrospect, agreement on a more rapid tariff phase-down might have resulted in less restrictive and generally more sensible rules of origin.

Among the most difficult sectors to deal with in the rules of origin negotiations were a) wheat flour and its products and b) clothing and textiles. In both cases, the disagreements arose between those Member States that produced important inputs for the goods in question and those that did not. For wheat flour and its products, the vital ingredient was wheat, and for garments it was fabric.

Member States in which there was significant production of these inputs (or hope of significant production in future)[12] wanted rules of origin that required that these inputs be sourced in SADC in order for the downstream product to qualify for SADC preferences. Other Member States saw such requirements as cost-raising burdens that served no purpose other than to restrict regional competition. In both cases, the Member States arguing for the less restrictive rules pointed out, quite correctly, that market conditions for the upstream products were such that the more restrictive rule (i.e. requiring use of these products) would be impossible to satisfy; in other words the restrictive rule of origin would prevent preferential trade ever from taking place in most Member States. This was the case for rules requiring exclusive or at least significant local sourcing for ingredients of blended teas, coffee and mixtures of spices.

In the case of garments, the rule that was eventually adopted was one that required that all of the material inputs into regionally produced garments, from yarn forward through fabric, must be sourced from within SADC in order to qualify for SADC preferences. As a concession to the poorest Member States (i.e. those classified as least developed countries or LDCs), however, it was agreed that garments must only be manufactured in these Member States, with no restrictions on fabric sourcing—i.e. the single stage transformation rule applied. However, this concession was granted only on a temporary basis and the quantity of exports that could benefit from it was quota-limited.[13]

In the case of wheat flour, no rule of origin was agreed. As a result, there were no circumstances in which wheat flour produced in any SADC Member State could qualify for SADC tariff preferences when traded in the region.

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[11] As we shall below, this has left some permanent legacies in the form of ongoing protectionist approaches to rules of origin in some countries (e.g. wheat flour in Zambia and Zimbabwe, and copper cable in Zambia).
[12] In some cases at least (e.g. wheat) such hopes were based much more on wishful thinking than on any scientific or other evidence.
[13] This became known as the MMTZ rule.

5. MID-TERM REVIEW AND FOLLOW-UP

The Mid Term Review of the implementation of the SADC Trade Protocol conducted in 2004 identified complex and excessively restrictive rules of origin as major impediments to achieving the goal of increasing trade in the region.[14]

The highly restrictive rules on textiles and clothing were highlighted in light of the demonstrated success of the single stage transformation rule under AGOA in promoting the growth of garment exports to the U.S. by qualifying SADC countries, and the discussions and negotiations that were beginning on the Economic Partnership Agreements (EPAs) with the EU. A major issue for many of the ACP countries was the need for a single stage transformation rule for the textiles and clothing sectors.

The report also highlighted the lack of agreement on a rule of origin for wheat flour and the excessively restrictive rules that had been agreed for a number of other processed agricultural products (blends of tea, coffee and mixtures of spices). In the manufacturing sector, the Review documented what appeared to be excessively restrictive rules on many other products, especially, but not exclusively in the machinery and electrical products sectors.

The report recommended a major overhaul of the SADC rules of origin, with the aim of simplifying them and most importantly of reducing their restrictiveness. The initially proposed rules of origin—i.e. those borrowed by, adopted by and currently in use by COMESA were suggested as the ideal solution. But otherwise, any reform that imposed more uniform rules across all manufacturing sectors and that were less restrictive in terms of local content requirements, maximum import content, and technical specifications of production processes was suggested as a useful goal of the exercise.

It was recommended as well that restrictive rules of origin not be used as a means of undoing the trade liberalizing effects of preferential tariff reductions negotiated in SADC. Countries that were reluctant to open up certain sensitive sectors to regional competition, should simply exclude them from their preferential tariff offers. This would allow other Member States to trade on preferential terms and not be blocked from doing so by restrictive rules designed to protect particular interests in one or two Member States.

Considerable progress has been made in reducing the restrictiveness of the SADC rules of origin. The process was somewhat tedious. It was conducted largely through negotiations, on a case-by-case basis, with stakeholders that might have been negatively impacted by any relaxation of the rules, rather than on the basis of more general principles about the national and region-wide benefits of liberalizing intra-regional trade. Nevertheless it has resulted in relaxation of many of the more restrictive rules, especially in key manufacturing sectors.

There remain a few processed downstream agricultural products (coffee, tea, and mixtures of spices) that continue to have unnecessarily restrictive local content requirements. But the two biggest problems by far remain wheat flour and garments.

[14] See Brenton, Flatters and Kalenga (2004).

In most of these sectors SADC has accepted the less restrictive EPA rules, and yet they remain reluctant to allow them to apply to preferential trade among themselves.

Wheat Flour

Incredible as it might seem there remains no agreed rule of origin for wheat flour. Although tariff phase-down offers for wheat flour were agreed some time ago and have all been implemented, the absence of a rule of origin makes it impossible for preferential trade in this product to take place.

As mentioned above, the conflict over this rule was between Member States that produced (or thought they could produce) significant amounts of wheat and those that did not. The wheat growing Member States wanted a rule requiring that flour be milled from locally grown wheat; the others wanted only a change of tariff heading rule—i.e. they wanted a requirement only that wheat flour be milled in a Member State, with no conditions on where the wheat was sourced.

The Member States that were most concerned with the more liberal rule were those that tried to protect their wheat farmers with an import duty. In the face of such an import duty, it was argued that

- local flour millers would be unable to compete with preferentially imported flour from other Member States whose millers had access to duty free wheat sourced elsewhere, and
- such competition would not only be harmful to local millers, but it would also undermine the protection provided to local wheat farmers.

Those arguing for the less restrictive change of tariff heading rule observed that

- even the largest wheat growing countries were net wheat importers and thus could not supply the wheat necessary for millers in other Member States to satisfy this rule,
- the effect of such a rule would be not only to protect millers and farmers in the wheat growing Member States, but also to prevent preferential trade from taking place among non-wheat-growing Members, and
- there was compelling evidence to suggest that, at least in South Africa, the wheat import tariff was providing little if any protection to wheat farmers and hence was not really raising milling costs in that country.

In any event, the main argument for the restrictive rule was soon made irrelevant by rising world wheat prices and the disappearance of the SACU import duty on wheat.[15] Nevertheless, resistance to the change of tariff heading rule continued, not only by SACU but also a number of other wheat-growing and non-wheat-growing Member States. This made it apparent that, as suggested in an earlier report for the SADC Secretariat[16] and then in the Mid-Term Review, that the real resistance to any rule of origin that would permit preferential trade in wheat flour came from milling

[15] The South African tariff formula for wheat and wheat flour links the tariff to the world wheat price. Once the price exceeds a certain level, the tariffs go to zero.
[16] For a more complete discussion see Erasmus and Flatters (2003) and Erasmus, Flatters and Kirk (2006).

groups that wanted to use import restrictions to reduce competition in their domestic markets and from governments that saw this as a reasonable type of industrial policy for this sector.[17]

Further evidence of this is provided by South African Competition Commission findings of anti-competitive behavior in the South African milling industry and by tax, tariff and non-tariff barriers on wheat flour and its products that have been put in place in a number of SADC Member States. Some of the latter are documented in other parts of this Trade Audit.[18]

Textiles and Garments

SADC continues to be divided over the appropriate rule of origin for textiles and garments. One group of countries supports the current rule, requiring that garments must be made from materials, from yarn forward, that are manufactured in SADC. The other group insists that the simple single transformation rule is most appropriate—i.e. that garments qualify for SADC tariff preferences as long as they are cut, made and trimmed in a SADC Member State, regardless of the source of the raw materials. This is the rule used in COMESA, the one that has supported the growth of garment exports to the US and job creation in a number of very poor SADC Member States as a result of AGOA, and the one that was fought for so hard (and successfully) under the EPAs with the EU.

The main argument for the yarn forward rule has always been based on a particular view of industrial policy for the textile and garment industries—that a competitive industry requires a fully integrated value chain and that the goal of government policy should be to promote all segments of that chain. A rule of origin requiring local or regional sourcing is seen as an instrument that will serve this purpose. This argument overlooks the cost-raising and hence competitiveness-reducing impacts of such requirements, and it ignores international experience in Southern Africa (especially but not exclusively with AGOA), in many parts of Asia, in the Caribbean and elsewhere where substantial industries have been built on the basis of occupying particular niches and sourcing inputs from the most competitive sources in the world. Competitiveness depends not on the existence of local value chains but rather on full, efficient and ready access to world markets. Success of particular industrial segments, of course, will almost certainly lead to increased local sourcing. But this process is and must be market driven rather than forced on investors by arbitrary government requirements.[19]

The real reason for the conflicting views on rules of origin in this sector can be found in differences in Member States' tariff structures for garments and textiles, and the differences in industrial strategies that they represent. In SACU, locally produced

[17] In 2006/7 the South African milling industry indicted its willingness to agree to a single transformation rule for wheat flour, subject to rule 2.5 of Annex 1 of the Trade Protocol. However a number of SACU Members continue to apply other trade restrictions to flour and other related products. See Flatters (2011b).

[18] See also Erasmus and Flatters (2003) and Flatters (2011b).

[19] Even the apparently rather innocuous requirement briefly added to AGOA rules, that producers of denim products should buy denim from local producers when it is commercially available, threatened to kill off one of the most successful AGOA exports before it was seen to be a mistake and withdrawn. See Flatters 2007).

garments are protected by import duties of about 45 percent (recently increased from 40 percent). Imports of fabric that are locally produced face duties of over 20 percent. SACU garment makers suffer a serious cost penalty from the high tariffs on fabric. However, the much higher tariffs on garments more than offset these penalties as long as garments are sold in the local market.[20]

The role of these tariffs in explaining the intransigence of SACU Member States on the rules of origin can be seen in the answers to two almost rhetorical questions.[21]

- *Question 1:* Why should SACU garment producers fear regional competition when allowing tariff-free intra-regional trade appears simply to put SACU producers on a level playing field, at least in terms of garment imports? Furthermore, they would still be protected by the 45 percent tariff against non-SADC imports (e.g. from China and the rest of Asia).

  Answer: It is the combination of tariff-free intra-SADC imports and the high SACU tariffs on fabric that is the problem for SACU producers. Non-SACU SADC producers would have a considerable competitive advantage *vis à vis* SACU producers if their governments allow duty-free imports of fabric. The SACU duties on fabric would put their producers at a significant cost disadvantage against such competition in the event of SADC free trade in garments. The same would be true of garment producers in any SADC Member State that use import duties to protect local fabric industries. A rule of origin that makes it difficult or impossible for non-SACU producers to take advantage of SADC tariff preferences would nullify this problem.

- *Question 2:* Given the immense value of the single transformation rule in promoting AGOA-related garment exports and employment in several of the smaller, poorer SACU countries, why do these smaller countries, especially Lesotho and Swaziland, support the yarn forward rule in SADC?

  Answer: As members of SACU, the BLNS countries have highly protected access to the South African market—the same as producers in South Africa. Following the most recent tariff rate increases on garments, a number of producers in Lesotho and Swaziland have shifted their focus from the AGOA market in the U.S. to SACU. This has been further encouraged by increased competition in the U.S. market due the disappearance of quota restrictions facing China and other Asian producers under the MFA and ATC. Under a single transformation rule of origin for garments in SADC, the BLNS might face serious competition in this market from other SADC Member States (see Question 1). Instead, as a result of the yarn forward rule currently in place, producers have closed factories in Malawi, for instance, and opened up new ones in Lesotho and Swaziland. Despite the value of the single transformation rule enjoyed by Lesotho and Swaziland under AGOA, they have no interest in applying the same rule to SADC. In fact, they have a strong interest in keeping the rule as restrictive as possible in order to keep out any competition from non-SACU SADC Member States.

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[20] See Flatters (2011a) for more details and for estimates of the magnitude of the subsidies provided by this tariff structure.
[21] See Flatters (2011a) for further elaboration.

The issue of the appropriate rule of origin for garments and textiles also came up during the EPA negotiations with the EU. Under South Africa's TDCA with the EU garments are subject to a restrictive double transformation rule—something South Africa was comfortable with since it would reduce EU competition facing South African garment producers in their local market. However, for most ACP countries involved in the EPA negotiations, this rule was seen as too restrictive since would hinder their ability to take advantage of EU preferences. In the end, the willingness of the EU to accept the single transformation rule was seen as a development-friendly decision on the part of the EU and as a negotiating triumph by most ACP countries. But the initial decision of several of the BLNS countries to accept the single transformation rule threatened to tear apart the so-called SADC negotiating group.

6. IMPLEMENTATION AND ADMINISTRATION ISSUES:

Three issues arise in the implementation and administration of SADC rules of origin.

Information

There appear to be some misunderstandings about the current status of various rules of origin. Despite a number of small but nevertheless significant improvements in the rules, not all actors seem to be fully aware of where they are at the moment. Updated rules are difficult to find on the SADC website. In one country visited as part of the current trade audit, the Customs official responsible for rules of origin had the mistaken impression that there exists no agreed rule of origin for automobiles.

These are relatively simple problems that can be solved through improved communication between the SADC Secretariat and Member States, among the Member States, and among Member States, the Secretariat and the trading community.

Compliance and Implementation Costs

Certifying origin under any set of rules is inherently costly. Simply collecting and documenting information on the division of costs between local and imported content is not a trivial exercise, and it is compounded many times over when the companies of individuals trading the goods across borders are not the actual producers of the goods. It would not be at all surprising if producers were reluctant to reveal proprietary information necessary to determine and if necessary verify origin, such as cost structures and input sourcing, let alone provide detailed inventory records to buyers of their products. These problems and the associated costs are inherent to any rules of origin regime.

At least one major South African-based retail chain has provided evidence that is now quite widely known of the costs it incurs in order to certify origin for a wide range of products it ships in SADC. The company ships thousands of different products on a regular basis. Certification of origin imposes a significant administrative burden, requiring dedicated staff to prepare and collect thousands of certificates per month, each with multiple signatures, required stamps and pages of export documents. This means a significant increase in import-export lead times and load preparation costs—a tripling of lead times and more than a doubling of load preparation costs (about 7 percent of shipment value for SADC shipments versus 2.5 percent for non-

SADC shipments).[22]

In light of these difficulties and costs it might actually be considered somewhat surprising that more than half of this company's shipments end up qualifying for SADC preferences. At least some of the goods shipped are imported from outside of SADC and/or have very little local/regional content and hence could not be certified as qualifying for origin under any circumstances. And other goods are probably subject to zero or very low MFN tariffs in the receiving countries, making it unnecessary to claim originating status. After accounting for both of these types of goods, the percentage of shipments that should but nevertheless fail to qualify for preferences for reasons of excessive compliance costs might be quite low.

For companies involved in shipping a narrower range of products, compliance costs are likely to be much lower than reported by the oft-quoted South African distributor and retailer.

None of this is an excuse, of course, for blindly accepting current levels of compliance costs. In particular, for companies like this large retailer, it should be possible to implement a less demanding list declaration procedure rather than requiring that origin to be certified on a product-by-product line basis as is the case now.

More generally, however, it is important to understand the real reasons for the compliance costs associated with rules of origin. While these costs are generally described as being due to the rules of origin, their real cause is the set of MFN tariff regimes in the SADC Member States. A commitment to more rapid MFN tariff reform to accompany the ongoing preferential reforms agreed under SADC, and to engage in more serious reform of other NTBs affecting intra-SADC trade would reduce the need for preferential rules that must, of necessity, be accompanied by costly systems for certifying origin.

Fraud

Taxes, import duties, licensing and other non-tariff rules, safety standards, rules of origin or any other requirements associated with importing and exporting, create an incentive for fraud. They create an opportunity for arbitrage; and the greater the restriction imposed by any requirement, the greater the risk that fraud will occur.

The possibility of import fraud was frequently discussed during the negotiation of SADC rules of origin.

In textiles and garments, for instance, South African negotiators frequently alluded to the threat of Chinese garments being shipped through, say, Malawi, being relabeled as products of Malawi and being re-exported to South Africa free of duty under SADC preferences. This is a clear example of fraud, under either a single transformation or a yarn-forward rule of origin. Nevertheless this threat was used as justification, not for improving systems for detection of fraud, but rather for implementing a yarn-forward rule of origin for garments.

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[22] See Charalambides (2010) and Gillson (2010) for an overview. Cost data quoted here were provided directly by the company.

The fear of smuggled Chinese garments was also used as an excuse for costly inspections of containers of garments being simply transshipped from BLNS countries to South African ports for exports to the US or elsewhere.

Similarly, in the case of insulated electrical cables, the risk that substandard imported copper or aluminium wires might be used in locally produced insulated products was put forward as a reason, not for improved enforcement of safety standards, but rather for the implementation of a rule of origin requiring that insulated cable use locally produced copper and aluminium wires. For anyone intent on fraudulent violation of safety standards, this would not prevent them from either falsely declaring imported wire to be locally sourced, or, without violating the rule of origin, using substandard local wire. A rule of origin is not a substitute for well-defined and properly enforced safety standards.

Excessively restrictive rules of origin are an inappropriate and costly way of dealing with import or other types of fraud.

7. CONCLUSIONS:

Negotiation of SADC rules of origin has been a long and unfortunately circuitous process. It began with quite a simple concept and a correspondingly elegant and appropriate solution. The underlying goal was to promote intra-SADC trade by eliminating import duties and other unnecessary restrictions. In order to accomplish this, it was necessary to define rules of origin that could be used to certify that goods claiming to be eligible for SADC tariff preferences actually originated in a Member State.

The solution was some general and very simple rules that defined a minimum level of processing or manufacturing activity necessary for this purpose, and that set out certain conditions or activities (labeling, packaging, etc.) that were not sufficient. The initially agreed rules for non-primary products set out three quite reasonable conditions, satisfaction of any one of which would suffice to confer originating status regardless of the good under consideration. For agricultural and other primary products, the condition was simply that the good be wholly obtained in a Member State.

Seeing the wisdom and practicality of SADC's decisions, COMESA adopted the same rules.

Before the Trade Protocol came into effect, however, a new dynamic took over, setting in motion a process in which the SADC rules were renegotiated on a sector-by-sector and product-by-product basis. The process was captured by special interests or their representatives in a number of Member States that felt they might be threatened by freer trade in the region. Rather than basing the discussions on the goal of increasing intra-SADC trade, the goal became one of using the rules to minimize "harmful competition" that might arise from regional free trade.

With a few key exceptions, a set of rules was eventually agreed. However, as was pointed out in the Mid-Term Review of the Trade Protocol, many of the rules were unnecessarily restrictive and undermined the intention of the Protocol to promote

intra-SADC trade. Furthermore, they often worked against even the special interests they were intended to support.

Since that time a slow but steady process has succeeded in rectifying many of the problems identified in the Mid-Term Review. For most manufactured goods, the rules are now relatively unrestrictive, and they are unlikely to be a hindrance to intra-SADC trade. There are still remnants of the protectionist approach that guided prior negotiations. For instance, conditions on maximum imported content vary unnecessarily across similar goods in the same tariff heading. There remain a few process conditions that in some cases simply add clarity and certainty, but in others once again reflect a misplaced desire to use the rules of origin to promote a particular industrial policy goal. But few of these conditions are a significant barrier to intra-SADC trade.

By and large most SADC rules of origin are now no more restrictive than those in COMESA or in the EPA deals agreed with the EU. Since the Mid-Term Review, for instance, the rules for HS chapters 84 and 85 have been significantly improved. In chapters 26 to 38, the choice of conditions available makes them less restrictive than COMESA's.

There remain a few problems in processed foods sectors (blended teas, coffee and mixtures of spices), where local content requirements are likely to continue to restrict trade and which actually fail to assist the primary product sectors they are intended to help. These should be cleaned up by agreeing to a rule that requires "manufacture from materials of any tariff heading" which is consistent with the EPA rules of origin.[23]

But the biggest problems remain

- wheat flour, where a rule has yet to be agreed, and
- garments and textiles, where the yarn-forward rule for garments remains an unnecessary and for many countries (including some of those that insist on keeping it) costly impediment to intra-SADC trade.

For wheat flour, the only sensible rule of origin is single transformation, or change of tariff heading, with no restrictions on sourcing of wheat. Apparently South Africa, one of the initial and strongest opponents of this rule, has now agreed to it, and only a small number of other Member States are holding out. If these Members are unwilling to allow intra-SADC free trade under these conditions, they should not continue to block other countries from doing so. They could protect their own millers, if they wish, by declaring this to be a sensitive sector and preventing preferential access to their markets by other Member States by postponing agreed tariff reductions.[24]

The only sensible rule for garments is also single transformation. Unfortunately a

[23] A change of tariff heading rule would not suffice since the inputs and outputs are classified in the same tariff heading.

[24] Or they could do as a number of other Member States have done by restricting imports of wheat flour through bans, licensing requirements or other quantitative restrictions. While such measures are contrary to the law and spirit of the Trade Protocol are widely used in the agricultural sector and are a far bigger threat than rules of origin to SADC trade integration.

number of Member States, especially South Africa, are intent on using high levels of tariff protection to shelter their garment industries from external competition and to insulate them from the cost-raising impacts of protection of their textile industries. Through their membership in SACU, producers in several of the BLNS countries also benefit from this arrangement. In these circumstances the purpose of a restrictive rule of origin for garments is to insulate the South African market from regional competition that might arise from SADC free trade.

This problem will continue as long as SACU continues its current tariff policy aimed at protecting its vulnerable garment industry.

Are there any solutions, other than liberalization of SACU's MFN tariff policies, in this sector?

Solution 1: As suggested above in the case of wheat flour, one solution might be to agree to a single transformation rule for garments, but for SACU to exclude this and maybe the textile industry from its preferential tariff offers. This would allow other Member States to trade under the single transformation rule. However, South Africa is by far the largest market for garments in SADC, and excluding this market from SADC preferences would remove most of the value of liberalizing trade in garments in SADC. It would not provide a market size that would be anywhere close to large enough to take advantage of competitiveness-enhancing scale economies. A SADC free trade arrangement that excludes the South African market would be of little economic value.

Solution 2: The other possibility would be to agree on a single transformation rule for garments, and for SACU to permit duty-free access to its markets by garment producers in all or at least some SADC Member States, but on a quota-restricted basis. This is similar to the arrangement that was made to allow some of the poorer Member States temporary access to the SACU market under a single transformation rule during the initial period of implementation of the Trade Protocol (the so-called MMTZ rule). Imposing quota restrictions would protect SACU producers from the unlikely possibility of a sudden large surge of competitive imports from SADC.

Neither of these solutions is particularly attractive. But either one would at least get over the hurdle of defining a sensible rule of origin for this sector, and would permit discussion to focus on the real issue of the appropriate trade and industrial policy for this sector

The few remaining problems with SADC rules of origin should be resolved in order to complete this part of implementation of the Trade Protocol. But aside from these few problems, rules of origin are no longer a major impediment to free trade in SADC and beyond. The bigger issues now arise from the approach and its underlying assumptions that led to the domination of rules of origin negotiations by special interests that saw the freeing of trade as a threat to rather than an essential part of a strategy for successful integration into global value chains. The fallout from this approach can be seen in the proliferation of many different kinds of barriers to intra-regional trade that are documented in other parts of the Trade Audit.

The few remaining problems with rules of origin will also need to be resolved in order to engage in meaningful discussions of rules of origin for an expanded Tri-Partite

Free Trade Area joining SADC with COMESA and the EAC. In all of the "problem" areas just discussed above, the simple solution will be to adopt a single transformation or change of tariff heading rule, or in cases where inputs and outputs fall under the same tariff heading, an appropriate value addition or local content requirement. This would make SADC rules consistent with those in the COMESA and the EAC. This solution is also consistent, of course, with the SADC goal of promoting trade among its own Member States.

Some observers feel that major differences in rules of origin will pose the greatest difficulty in coming to an agreement on a Tri-Partite FTA. The biggest obstacle in this regard will be the difference between SADC's list rules and the general non-sector-specific rules in COMESA.

However, negotiators should not confuse this with the existence of serious substantive differences in the restrictiveness of SADC and COMESA rules. As observed above, the amendments following the Mid-Term Review have resulted in rules that, with the few exceptions identified earlier, are good for SADC and compare relatively favorably with those in COMESA and elsewhere. Precise comparisons are made difficult by differences in measuring value (factory cost versus market price) and by a variety of product-specific process requirements.[25]

What is to be avoided if at all possible is a repetition of the SADC experience of (re)negotiating rules on a product-by-product basis based primarily on inputs from special interests reluctant to face increased regional or international competition in their local markets. To avoid this it would be wise to sequence negotiations in such a way that rules of origin are determined before agreement is reached on tariff reduction schedules and even on the principle of duty-free, quota-free trade across all tariff lines. This would allow Member States to protect "sensitive" sectors by delaying or excluding liberalization in such sectors without having to resort to rules of origin that would prevent preferential trade among all other Member States as well.

SADC, COMESA and EAC rules are no longer significantly different in their substantive requirements. It should be possible to bring them into harmony without endangering the more general and important goal of expanding trade in the region and global competitiveness of regional producers through enhancing and reducing barriers to intra-regional trade. Rules of origin are no longer and should not be allowed to become again a major obstacle to achieving this goal. This way attention can be focused on the more important impediments to regional integration in SADC and beyond.

[25] The original SADC and current COMESA rules were/are both based on factory cost. EU rules are based on factory price. The U.S. uses both, allowing for a "built-up" or "built down" method of calculation, with the difference between the two calculations generally in the range of 10 percent—e.g. 35 versus 45 percent value added. In the SADC rules, 60 percent imported content requirements are based on factory price (and therefore 40 percent local content requirements on factory price). The factory price method is less demanding administratively since it does not require Customs to do reviews of cost structures.

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