

Rules of Origin as Tools of Development? Some Lessons from SADC

**Hennie Erasmus, Frank Flatters, and Robert Kirk
October 2004**

This paper is based in part on earlier USAID-supported work for the SADC Secretariat. We are grateful to IADB, Fédération Paris-Jourdan , ADRES, INRA and CEPR for facilitating the updating and completion of the work in its present form. The paper has also benefited from presentations and discussions at an authors' meeting at INRA, Paris in May 2003. Numerous officials in SADC member states, representatives of private firms in many industries, and researchers in the SADC region provided valuable information and many useful insights through interviews, workshops, seminars and informal discussions. They would not all agree with all the analysis and conclusions presented here. For that reason their inputs are even more greatly appreciated. The views expressed in the paper are those of the authors and should not be attributed to the IADB, USAID, SADC Secretariat, any of its member states or any of the staff or officials of these organizations. Hennie Erasmus is Senior Trade Expert at the SADC Secretariat, Gaborone, Botswana. Frank Flatters is Professor Emeritus of Economics at Queen's University, Canada, and Robert Kirk is Vice-President, Trade Policy and Economic Development at The Services Group (TSG) in Arlington, Virginia.

Rules of Origin as Tools of Development? Some Lessons from SADC

Hennie Erasmus, Frank Flatters, and Robert Kirk

1. Introduction

There are two quite different and competing economic visions of Southern African Development Community (SADC). The alternate policy directions they imply are well illustrated in the negotiation of rules of origin under the SADC Trade Protocol.¹

- The first vision is of SADC as a fortress within which member states can develop themselves through privileged access to an enlarged market area that remains protected and relatively isolated from external markets.
- The second vision sees SADC as a platform for directly improving the competitiveness of individual members in international markets and/or for improving consumption opportunities of their citizens. Regional integration is seen as part of a more general strategy for full and meaningful participation in global markets.

The vision that has driven the development of the SADC Trade Protocol has been distinctly inward-looking. Development of policies on rules of origin has responded defensively to fears of external (international and regional) competition and proactively to desires to develop linkages through administrative requirements. A central issue has been the extent to which rules of origin can or should be used to promote economic development in the region. In this sense, rules of origin are similar to local content regulations, a more familiar tool that is a common feature of failed import substitution regimes. Little attention has been paid to the Trade Protocol as an instrument to capitalize on opportunities for improving international competitiveness and for participating in global markets.

Rules of origin have been among the more contentious issues in SADC Trade Protocol negotiations. Indeed, even four years after implementation of the Protocol, rules have not yet been agreed in some sectors. In many sectors in which rules have been agreed, resolution of outstanding differences has been put off for consideration in a mid term review of the Trade Protocol that is currently underway.

Rules of origin are an essential element of regional trading arrangements. But their use as protectionist devices, whether in North-South or South-South agreements, can also undermine and subvert the benefits of the trade liberalization they are meant to support. This is one of the great dangers of regionalism as a strategy for global integration.

The paper is structured as follows. Sections 2 and 3 present the general context, focusing on the roles of international fragmentation of production and trade in middle products in economic development (Section 2) and on the purposes, types and effects of rules of origin, and their evolution in SADC (Section 3). Sections 4 and 5 provide a detailed and critical analysis of selected SADC rules of origin in agriculture (Section 4) and manufacturing (Section 5). Section 6 discusses links and lessons from this work on SADC for other studies included in this project. Section 7 briefly summarizes the principal conclusions about rules of origin in SADC and in preferential trading arrangements (PTAs) more generally.

¹ See Flatters 2001.

2. Background

To put the discussion of rules of origin into a broader context, we begin with a brief review of lessons from several strands of recent literature on trade and development.

2.1 Trade in Middle Products

Following on the earlier theory of effective protection which recognized the key role of intermediate inputs in shaping the protective effects of tariffs, Sanyal and Jones (1982) and later Jones and Kierszkowski (1990, 2001a, 2001b and 2001c) set out a framework for analyzing international ‘fragmentation’ of production and the corresponding necessity for trade in ‘middle products’. Improvements in the infrastructure of trade and investment create enormous possibilities for the international division of labor and for the global spread of production according to differences in relative costs at different stages in the production process and in different markets. This is really a formalization and extension of Adam Smith’s insight into the economic gains from specialization.

This framework also focuses attention on the role of international transport costs and of the costs and efficiency of a variety of non-tradable services from telecommunications to ports and customs administration in shaping possibilities for international production sharing.

The twin phenomena of fragmentation of international production and the large share of international trade in middle products are central features of globalization. In products from autos and electronics to garments, manufacture of subcomponents and assembly of components and of final products can and do take place in many different locations. The geographic distribution of these activities can be sensitive to small changes in local cost conditions and in the cost of international transport and communications. Systematic changes in these conditions in the process of a country’s development produce corresponding changes in the local mix of production and assembly activities.

The study of fragmentation of production sheds new light on the link between exports and imports. To participate as a successful exporter in the global manufacturing system a country must be a successful importer; flexibility and low costs in sourcing imported materials are critical ingredients in exporting. Slow and/or costly Customs and port procedures raise the cost of importing; administrative requirements on the sourcing of inputs raise costs and reduce flexibility. They raise the cost of undertaking any stage of the production process and so reduce investment and exports.

2.2 Lessons from Southeast Asia and Elsewhere

2.2.1 Southeast Asia

Southeast Asia integrated highly successfully into the global manufacturing system in the final decades of the twentieth century. While the lessons of this experience remain the focus of considerable analysis and debate, certain things are clear. One is that the success of Southeast Asian exporters depended heavily on access to imported inputs. There are few examples of successful manufactured export activities that involved full manufacture of components and final products in a single country. Production of components and subcomponents of almost all products was scattered across many locations according to local cost conditions. The standard pattern, of course, was for skill and capital intensive parts of production operations to take place in higher income countries and for labor intensive activities to be undertaken in low income countries.

The pattern was far from static, however. As skill levels and wages rose countries specializing in labor intensive production moved ‘up the ladder’ to more skill and capital intensive activities. But regardless of what took place in any location, production remained heavily dependent on imports.

Another lesson was that there are limits to the degree of production fragmentation that is possible or desirable. Benefits of close communication and the costs of transporting goods over long distances and across international borders mean that assemblers or producers of components always prefer, all other things equal, to have subcomponents suppliers close at hand. The degree of local sourcing (or

the limits of international fragmentation of production) depends on a trade-off between the centrifugal force of differences in relative production costs and the centripetal force of proximity advantages.

As Japanese and Korean television or VCR producers responded to labor cost differences by moving assembly operations from Malaysia to Indonesia, for instance, they worked closely with components and subcomponents suppliers in the region and in their home countries to persuade them to invest near their new factories in Indonesia. According to one investor, moving an assembly operation from Malaysia to Indonesia with no change in existing local supply networks would increase production costs by 20 percent. However, when capacities of local sourcing industries reached Malaysian levels, Indonesian costs would be 20 percent lower than in Malaysia. Investors in electronic assembly industries had a strong incentive to encourage the development of local supply networks.²

The key to the development of local supply networks, however, was not to force them through local content rules, but rather to clear the way for development of downstream production in order to create a demand for the products of upstream suppliers. This meant facilitating trade and investment through regulatory and tariff reform, improving port and customs services and removing administrative barriers. Having chosen to invest in a particular location, internationally experienced and competitive downstream producers then play an important mentoring role for local suppliers with respect to product design, sourcing of materials, production methods and logistics, thus ensuring to the greatest possible extent that they become internationally competitive suppliers.³

Some policy makers have taken exactly the wrong lesson from the observed correlation between the development of competitive downstream producers and upstream sourcing industries, and have tried to force the development of upstream suppliers. High tariffs designed to encourage local production of consumer goods for local markets encouraged the development of small scale and high cost local assembly industries. Disappointed by the low levels of local content policy makers devised complex tariff rate structures, often combined with specific local content rules intended to encourage the development of domestic supporting industries. The almost inevitable result was not the development of internationally competitive industrial ‘clusters’ but rather high cost import substitution enclaves for which consumers paid a double price through protection of the original product and the further increase in costs incurred in meeting local content requirements.

2.2.2 Mauritius

Mauritius is a member of SADC and is one of the few African successes in global integration. At independence Mauritius’ economic prospects were bleak.⁴ It was among the poorest countries in the world. The population was too high to be supported by the island’s limited land and natural resources. Any wage sufficient for landowners to hire the available labor force would be too low to support a subsistence standard of living. It appeared that the only hope was large increases in sugar yields or significant increases in world sugar prices. Neither of these was very likely. Mauritius appeared to be stuck in a Malthusian trap, condemned to grinding poverty, inevitable ethnic strife and political and economic instability.

Thirty years later Mauritius would be unrecognizable to those who participated in British-commissioned studies at independence. Per capita income (PPP adjusted) is more than 5 times higher than the average for Sub-Saharan Africa and more than two and a half times that of all developing countries. Rates of growth and other human development indicators outperform these other countries by a wide margin.

² Source: author’s (Flatters) interviews in Malaysia, Indonesia and Singapore.

³ This key role of export-oriented international investors in attracting and mentoring upstream suppliers is a major theme of Moran 2001.

⁴ For an elegant and highly readable overview of the findings of British government-commissioned studies at the time, see Meade 1964.

Central to this achievement have been:

- recognition of special opportunities available in world markets, and
- trade promoting policy reforms – facilitation of the import of raw materials and the export of processed products, with minimal regulation or other interference.

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

At the same time, an interesting feature of trade policy over the same period has been the continuation of relatively high rates of protection to a wide range of import substitution industries. Until very recently, the tariff structure has been characterized by high and variable rates, with an escalating pattern that encouraged inefficient local assembly industries. A long-entrenched myth about the importance and fragility of such import substitution industries perpetuated a high cost policy regime for an unusually long time.

It is only relatively recently, after recognizing the small amounts of employment in these industries and the high costs they impose on consumers, and after introducing a VAT which reduces budgetary reliance on import duties that Mauritius has begun to rationalize its import duty regime.⁵

It is a testimony to the effectiveness of the EPZ system and to the market-friendliness of the rest of the investment and industrial policy regime that the export-oriented economy in textiles and other sectors developed so successfully in spite of these persistent import substitution measures. Mauritius now exports a wide range of manufactured products, including of course garments and textiles, but also sunglasses, watches and their parts, medical equipment and many other goods. In addition she continues to earn considerable income from tourism, and has begun to export banking and information processing services.

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

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

2.2.3 Summary of General Lessons

The broad lessons from international experience are clear. Participation in global markets is a necessary condition for sustainable economic development and poverty reduction. The extent and type of participation of any country is largely the result of its own policy choices. Countries that have pursued relatively open trade policy regimes have performed better than those that have not. No country that has closed itself from world markets has achieved rapid economic growth.

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

⁵ See Box 7 of Flatters 2002b.

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

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

3. The Functions of Rules of Origin⁶

3.1 General Uses of Rules of Origin

Rules of origin are required in any preferential trading arrangement (PTA) in order to *authenticate* that goods claiming tariff preferences result from significant economic activity in an eligible country. The rules prevent ‘trade deflection’ – importing products from outside the PTA into a member country with a relatively low external tariff and re-exporting them under PTA tariff preferences into another member with a higher external tariff. Their importance depends on the height and intra-PTA variance of external tariffs. The greater are the height and variance of external tariffs of PTA members, the greater will be the dangers of trade deflection.

The basis for rules of origin in most PTAs is the definition of a minimum level of processing or manufacturing within the region as a requirement for preferential tariff treatment.

A second purpose for which rules of origin are sometimes used is to encourage certain regional activities or to protect them from potential competition arising from the formation of the PTA. This is the *protective* effect (intended or unintended) of rules of origin. This protection can be of two forms – preventing the emergence of regional competition as a result of regional trade liberalization, and encouraging regional production of intermediate or primary products.

- Restrictive rules of origin deprive producers of access to raw materials or intermediate products from low cost international sources and hence raise the cost of producing for sale in the PTA.⁷ If they have any effect at all, they force producers to source inputs locally when they would not otherwise have done so, forcing them into cost-raising production patterns. This reduces the ability of producers to take advantage of regional preferences. In this way restrictive rules of origin shield existing producers from new regional competition, and deprive consumers from potential benefits of regional tariff reductions.

This is sometimes rationalized as a defensive measure to protect producers from cost-raising effects of their own countries’ MFN import tariffs on raw materials and intermediate inputs. Forcing potential regional competitors to operate under similar policy-induced handicaps has no economic rationale. At best it makes the PTA irrelevant for globally competitive producers who source materials from the best international sources. At worst it induces producers to adopt high cost production methods, simply to satisfy a rule of origin.

- Strict rules of origin can induce producers to use regional raw materials, thus giving protection and encouragement to the producers of such goods. Such an incentive is necessary only to the extent that their local/regional costs of these materials are higher than international prices of the same goods. Therefore, the burden of rules of origin designed for this purpose are borne in the form of higher costs by downstream user industries, making them less competitive internationally and forcing them to charge higher prices domestically. Such a strategy reduces rather than increases the global competitiveness of regional producers and deprives consumers of the benefits of trade liberalization.

⁶ This section draws on Flatters 2002b.

⁷ Producers are free, of course, to source raw materials wherever they wish, subject to import regulations and taxes in their own countries. But if they do not meet the requirements of the PTA’s rules of origin, they will not qualify for preferential access to other markets in the PTA.

Rules of origin can have substantial protective effects. To reduce tariffs on regional trade only to replace them with less transparent and often more restrictive rules of origin is a questionable way to achieve the benefits of trade liberalization.

3.2 Proposed Uses of Rules of Origin in SADC

Under some interpretations the SADC Trade Protocol rules of origin are intended to be used not only for authentication, but also to serve a broader developmental role. The ‘developmental’ function is justified by Article 2 of the Trade Protocol which identifies the enhancement of economic development, diversification and industrialization of the region as major goals. This has been seen as counsel for protection as a development tool, getting to the heart of much more general debates about the role of trade polices in development.

Proposed uses of rules of origin in SADC have not been confined to authentication and protection. Other justifications have included consumer and industrial safety, environmental protection, and preventing the dumping of foreign goods in regional markets.

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

Fears have been expressed that the ‘normal’ instruments for dealing with these problems might not work. This is not an argument for using rules of origin; rather, it points out the need to improve the design or implementation of the normal tools. The use of restrictive rules of origin would be a much less effective (often completely ineffective) and more costly alternative.⁸

Another frequently expressed belief is that regional Customs administrations are incapable of enforcing rules of origin. As a result, it is feared that low cost goods from Asia will enter SADC through porous borders of weak member states, be granted SADC tariff preferences, and destroy regional industries. More restrictive rules of origin are the suggested solution. This begs the question of why a weak administration should be more capable of enforcing complex and restrictive rules than simpler and less restrictive ones.

Solving problems of weak administration by making it difficult, if not impossible, for any trade to qualify for SADC preferences subverts the trade liberalization process. Improving administrative systems and capabilities would be a more direct, appropriate and less costly alternative.

3.3 Evolution of SADC Rules of Origin

The rules of origin in the original SADC Trade Protocol were simple, general and consistent with those in other developing country PTAs, including most importantly neighboring and overlapping COMESA.⁹ 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. Under the specific rules goods would have to undergo a single change of tariff heading, 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.

⁸ See Box 2 of Flatters 2002b for a discussion of a proposal to use rules of origin for the enforcement of safety standards for electrical cable.

⁹ 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.

Certain member states, led by South Africa, pressed for exceptions to these rules. South Africa accounts for over 75 percent of SADC GDP and is the only member state with a significant manufacturing base. After signaling his government's intent to promote regional free trade, South Africa's Minister of Trade then clarified that this was subject to the important constraint that it not endanger existing domestic industries. In particular, for goods to benefit from SADC preferences, they must be 'genuinely produced in SADC'. This was interpreted to mean that if an intermediate product was produced within SADC it should be used instead of one from outside the region.

This led to the development of a regime of more restrictive sector-specific rules. Most of the arguments for such rules boiled down to attempts to increase or preserve protection in domestic markets. The rule of origin regime in the amended Trade Protocol is very different from what was originally agreed, characterized by made-to-measure product-specific rules that are far more restrictive. The change of tariff heading requirement has been replaced by multiple transformation rules and/or detailed descriptions of required production processes. Value added requirements have been raised, and permissible levels of import content have been decreased.¹⁰

The rules are now much more like those in the EU and in PTAs with rich, highly industrialized countries.¹¹ They are most similar to the rules in the EU-South Africa and EU-ACP trade agreements. This is no coincidence. The EU-South Africa rules were often invoked by special interests in South Africa as models for SADC. Such claims were too often accepted at face value and not recognized as self-interested pleading for protection by already heavily protected domestic producers. There were little or no discussion about the appropriateness of the underlying economic model (whatever it might be) for SADC.

The complex and asymmetric pattern of tariff phase down schedules agreed under the Trade Protocol was another factor in shaping the rules of origin. Undue attention was paid to transitional rules rather than the end product. During the transition it was agreed to permit the relatively less developed member states to phase down their tariff rates at a slower rate than South Africa/SACU.¹² 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.¹³

The complexity of the compromises involved in the tariff phase downs made it virtually impossible to reopen discussions later to deal with unforeseen problems.¹⁴ This placed the burden of dealing with any *ex post* complaints of 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 wonderful tool. The ability to appeal to the 'EU model' added further credibility to the process of tightening the rules.

The following sections discuss and summarize the findings of numerous case studies of the effects of alternative rules of origin discussed in the development of the SADC regime.

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

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

¹² SACU is the Southern Africa Customs Union and comprises Botswana, Lesotho, Namibia, South Africa and Swaziland. With a common external tariff SACU presented one tariff phase down offer to the rest of SADC.

¹³ This transitional asymmetry was even carried over into rules of origin in the textile sector.

¹⁴ 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.

4. SADC Rules of Origin: Agriculture and Processed Agricultural Products

The SADC economies are still heavily dependent on agriculture and on other primary products. For those who see rules of origin as a development tool, these sectors are important targets. The ‘EU model’ has provided considerable guidance.

As already observed, primary agricultural products must be wholly produced in a member state in order to qualify for SADC preferential tariffs. This ensures that products produced elsewhere do not gain access to preferences by being imported initially into a low tariff member state market.

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

- Requiring the use of regional raw materials will protect and/or encourage development of local agricultural production. Without such protection processors, especially those in member states with low agricultural tariffs, will harm regional producers by substituting international for regional raw materials. Restrictive rules of origin on processed products will do the opposite and increase demand for regional agricultural products.
- Insisting on the use of regionally produced raw materials will encourage greater regional value added in agriculture. Rather than exporting unprocessed raw materials, restrictive rules of origin will encourage further downstream processing.

These arguments have been heard in many forms in many agricultural sectors. They often have been used together, with no apparent recognition of the inherent contradiction between them. Underlying the discussions in some key sectors as we shall see has been a third, often unstated presumption – that requiring the use of local raw materials will reduce the amount of competition in markets for processed goods as a result of SADC tariff reductions.

In any event, following the ‘EU model’ and what were perceived to be the interests of agricultural producers and processors, the rules of origin for many processed agricultural products require that many of the raw materials used be wholly originating in the region in order for the regionally processed products to qualify for SADC preferences.

The most interesting and informative cases during the negotiations were sectors in which the absurdity of such a rule was too great to be ignored. We briefly discuss a few such cases here.

4.1 Wheat Flour¹⁵

The rule of origin for wheat flour and its products have not been agreed. The main differences among the proposed rules for flour hinge on the amount of local/regional wheat that is required. At one extreme is a proposal requiring that 70 percent of the wheat used (by weight) be sourced in the region. At the other is a rule that requires simply that the flour be milled in the region – i.e. that wheat undergoes a change of tariff heading. The main differences in the proposed rules for downstream flour products also relate to whether there are any requirements on the local wheat content of flour used.

There are 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. South Africa is by far the dominant producer, in terms of both total production and the proportion of domestic demand that can be met from local production.

Some member states have a history of providing considerable protection to local wheat growers and others provide none. Similarly, there are large variations in the amount of protection given to

¹⁵ The argument in this and the following section is developed in more detail in Erasmus and Flatters 2003.

downstream producers of flour and its products. There has been significant and rapid deregulation in these industries in some member states recently, especially South Africa.

Member states with large and protected wheat and wheat flour industries have resisted liberalization of intra-SADC trade. In particular, they have advocated restrictive rules of origin as a means of insulating their producers against competition from other member states.

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

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

The discussions have raised questions about downstream milling industries. 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 for consumers of flour and flour products in member states.

Less openly discussed, but of equal or maybe even greater importance has been the type and extent of protection of SADC milling industries. How much protection is currently enjoyed by different SADC milling industries? How will this protection be affected by intra-SADC free trade under different rules of origin?

Tanzania and South Africa are the only members to place significant import duties on wheat. Tanzania's MFN duty is 25 percent, while South Africa has a specific duty that is triggered by a world price less than its 'long term average.' Whenever this happens the specific duty is set at the difference between the actual and long term average wheat price.¹⁶ The actual duty has been zero or very close to zero for the past two years.

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

However, any rule of origin requiring significant amounts of regionally sourced wheat could never be met by non-SACU millers. Therefore a rule of origin allegedly designed to protect South African millers and grain growers would also prevent all preferential SADC trade among non-SACU members. Only SACU millers would ever be able to satisfy the South Africa-proposed rule of 70% local content by weight.

A closer study of the South African/SACU grain markets reveals another problem with the South African justification for a restrictive rule of origin. In recent years at least, the SACU wheat tariff provides very little if any assistance to local grain growers. For the past two years the duty has been set at zero or close to zero. Previously, under the competitive structure of the grain market (few buyers, many sellers), domestic wheat prices in South Africa were equal to or less than the import parity price before import duty.¹⁷ In some regional markets they were closer to export parity than to

¹⁶ While the SACU wheat duty applies to all SACU members, all except South Africa provide a full rebate. The stated purpose of the rebate is to reduce the cost of flour, an important ingredient of many basic foodstuffs.

¹⁷ See Box 2 of Erasmus and Flatters 2003.

import parity. Simple evidence is provided by the preference of non-South African SACU millers to purchase local South African wheat even when they could use the rebate facility to buy imported wheat on a duty free basis. In other words, the South African wheat tariff has not helped grain growers and has not imposed a significant cost penalty on millers. The only negative impact on millers is the effect it has on the price of imported wheat, which comprises only 20 to 30 percent of their needs.

What protection is given to the SADC milling industries? All member states except Malawi tax imports of wheat flour. Outside of SACU these duties range from 15 to 40 percent. The SACU duty is more complex. Until the beginning of 2003 it comprised two elements, a specific duty equal to 150 percent of that on wheat, and an additional *ad valorem* duty that started at 40 percent several years ago, had been phased down to 10 percent in 2002 and to zero in 2003.

MFN tariff structures in the early stages of the SADC negotiations gave substantial protection to millers in most SADC member states. Effective protection to milling most member states ranged from 25 to 127 percent. Only Malawi and Mauritius gave no protection to local milling industries. In more recent years, with the disappearance of the duties on wheat and flour, SACU millers received no effective tariff protection.

Within each domestic market, most SADC milling industries have tended to be oligopolistic and face little threat from external competition. It is understandable that they would wish to use rules of origin to protect them from new regional competition from SADC.

The SACU millers have been quite successful at delaying preferential trade in wheat flour. Tariff phase-downs on wheat flour are among the slowest in all sectors. A number of member states have erected non-tariff barriers against imports of wheat flour, the most notable of which is a recently enacted ban on all wheat flour imports in Namibia (a member of SACU). And the milling industries, especially those in SACU, have captured almost complete control of negotiations in this sector and have ensured complete deadlock so that no rule can be agreed.¹⁸ Claiming to represent the interests of South African wheat farmers against those of non-South African millers, the major South African flour producers have convinced negotiators that any non-restrictive rule of origin will provide a back door through which SADC free trade in flour will destroy the South African grain industry, despite the fact that current protection, at most, helps only millers and provides no benefit to grain growers.

Rent-seeking behaviour by key stakeholders has stalled regional trade liberalization in this sector and has even created new trade barriers. Incorrect but nevertheless plausible sounding claims about support for agriculture have been manipulated to justify policies that benefit particular parties but deliver none of the promised benefits to the supposed beneficiaries.

Similar but even less plausible arguments are being used to argue for the use of flour milled from local wheat in downstream flour products such as bread, pasta and biscuits. As with wheat flour, no rule has been agreed.

4.2 Coffee, Tea, Spices and Other Processed Agricultural Products

Member states in which there is significant primary production of coffee, tea, spices or other agricultural products, and especially those which impose significant external tariffs on these products have often advocated restrictive rules of origin (high regional content requirements) for their downstream products, and those that are not major producers of the raw materials generally prefer less restrictive rules. The raw material producers have tended to have a louder voice and greater influence.

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

¹⁸ Senior management from the major milling interests are principal actors at all trade negotiating meetings and have played significant roles in writing the position papers for several of the member states.

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

The original chapter rule for coffee, tea and spices required that locally produced materials account for at least 80 percent by weight of the final product in order for them to qualify for SADC tariff preferences. The only exception was for mixtures of spices where the requirement was that at least 80 percent of the *value* of the final product (*ex works price*) be attributable to regional inputs. Following pressure from non-producing member states it was eventually agreed that:

- for tea, coffee and spices at least 60 percent by weight of the raw materials must originate in the region, and
- for curry and mixtures of spices, there must be a change of tariff heading and all cloves used in such mixtures must be wholly originating in the region.

For many other products, the rules require that certain primary products produced in the region be fully sourced in the region in order for the downstream products to receive SADC tariff preferences.

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

Two of the keys to successful downstream coffee, tea and spice blending are a) sourcing a variety of appropriate raw materials – in terms of quality, price and other characteristics – for blending purposes and b) efficient processing, creative packaging and marketing of the final products. See Box 1 for the case of instant coffee.

1. International Sourcing for Instant Coffee

As is well known to any aficionado, ‘coffee’ is not a homogeneous product. With few exceptions, most coffees available in the market are blends of beans from different sources, each with its distinct taste characteristics.

Instant coffee is no different. Coffee producers source beans from around the globe in light of differences in price, quality and flavor. For example one major manufacturer in SADC sources beans from at least seven different countries in order to achieve a product at the right cost and with the appropriate flavor. The basic mix is roughly 60% robusta and 40% Arabica. Suitable robusta is not available anywhere in the SADC region, and so it is sourced in other parts of Africa (mainly Ivory Coast) and Asia (primarily Indonesia and Vietnam at the moment). Arabica is sourced in a number of countries, including South Africa, Tanzania, Uganda and Zimbabwe. Overall, however, only five to ten percent of their coffee inputs are sourced in SADC.

The low degree of local sourcing is of no consequence to regional growers. Arabica coffee grown in the region is sold internationally – indeed some high quality Arabica products command very high premiums in Europe and other international markets. Increased local sourcing by regional processors would not affect the world prices of these products and hence would be of no benefit to local growers.

Instant coffee production is a substantial manufacturing process, with value added in the range of 40 to 50 percent of the *ex works price*. The rule of origin for chapter 21 which includes instant coffee puts an upper limit of 60 percent of the *ex works price* on the amount of imported materials that can be used. A 70 or 80 percent regional content requirement as was originally for processed coffee and tea would make regionally manufactured instant coffee ineligible for SADC trade preferences.

Source: Case study interviews. See Flatters 2002b.

High quality coffee, tea and spices are grown in a number of SADC Member States. A wide variety of lower quality products are also grown. Many of these products are exported internationally. Those of higher quality command correspondingly high prices in world markets. Growers' participation in international markets means that restrictive rules of origin in SADC will have no effect on them. Any sales that might be diverted to regional markets as a result of restrictive rule of origin would simply replace one customer by another, with no impact on the sellers or the producers of the raw materials. A restrictive rule of origin for coffee, tea or spices will be of no benefit to local growers.

Consider the case of Tanzania, a competitive world producer and net exporter of coffee and cloves. Any diversion of its coffee or cloves to local or regional use would simply detract from international exports, with no net gain. The world price would obtain in either case.

Furthermore, a restrictive rule of origin for these products will not assist in the development of downstream processing industries. In fact, it would most likely have the opposite effect; it would decrease the overall competitiveness of coffee, tea, and spice processors. However, it would prevent any new competition for existing producers arising from SADC tariff reductions.

Processed coffee, tea and spices are heterogeneous and highly differentiated products. The raw materials used are similarly heterogeneous and their characteristics are generally very location-specific – a product of climate, soil conditions and many other factors.¹⁹ Relative to the variety of raw materials available in the world, SADC Member States produce only a very narrow range and a similarly limited set of varieties of the few products that are grown in the region.

Producers would prefer to source locally whenever possible – for reasons of transport costs, speedy and reliable communication with suppliers, etc. They work closely with regional suppliers and growers to develop local sources of raw materials where this can be done competitively.

For some products such as rooibos tea,²⁰ the raw materials can be obtained only in the SADC region. For others, such as Ceylon tea, green tea and many of the raw materials that are essential in curries and other mixed spices, there are no local sources of supply in SADC. Branding, licensing, local health regulations and many other factors often determine where inputs must be sourced, and rules of origin cannot be used to overcome these requirements. Skillful sourcing and selection of raw materials in the global market is a key to the international competitiveness of these producers. Therefore, restrictive rules of origin simply hinder the development of downstream processing industries. See Box 2 for an example from another sector.

2. Gherkins: The Need for Flexible Sourcing of Raw Materials

An example from a different tariff heading illustrates the importance of flexibility in sourcing raw materials and the absurdity of rules such as those governing coffee, tea and spices. A company investigated in the course of this work produces a wide variety of food products, including pickled gherkins.

Gherkins are grown competitively in SADC and the company routinely buys locally. However, a recent crop failure created an emergency and required the company to source gherkins from Turkey, at considerable extra cost. Under a restrictive rule such as those proposed for coffee and tea, the use of imported gherkins would disqualify these pickles from SADC trade preferences. This would provide no benefit to local gherkin growers and would be harmful to regional producers and consumers.

In any other year, the rule would be easily satisfied. But it would be redundant; producers would source locally regardless of the rules of origin. In normal years, the restrictive rule would be unnecessary, and in unusual years, such as that described here, it could not be fulfilled and would only cause harm to local producers and consumers.

Source: Case study interviews. See Flatters 2002b

¹⁹ The time, effort and resources devoted to exploration and colonial wars over several centuries in China and the East Indies is testimony the location-specific nature of growing conditions for a wide variety of spices, teas and coffees.

²⁰ This is a popular herbal tea in South Africa and the region, made from the leaves of the “red bush.”

There are a number of internationally successful SADC producers of processed agricultural products. They already export within the immediate region, to the rest of Africa and many other places, including Asia, Europe and North America. Arbitrary and restrictive rules that limit flexibility in raw material sourcing will reduce their competitiveness and harm regional consumers.

Restrictive rules of origin would exclude from SADC preferences most of the products currently produced in the region, including many in which non-preferential trade is already taking place. Even member states that might have some comparative advantage in tea, coffee or spice blending by virtue of local availability of some of the necessary ingredients would be deprived of preferential access to SADC markets under current rules.

5. Manufacturing Industries

5.1 Light Manufacturing

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

The initially proposed general rule for products in Chapters 84, 85 and 90 was that non-originating raw materials used could not exceed 65 percent of their *ex-factory* cost. In other words, a minimum local/regional content of 35 percent of *ex-factory* cost was required.

The basis for value calculations was then changed from *ex-factory* cost to *ex-works* price and the domestic content threshold was raised to 40 percent (i.e. the maximum import content became 60 percent of the *ex-works* price).

The more interesting story concerns the exceptions to the chapter rule. Several member states, most importantly South Africa, identified certain chapter sub-headings in which they had a special interest and for which they advocated more restrictive rules. As might be expected, these were subheadings in which South Africa had existing (or potential) producers selling behind high import tariff barriers.

After tortuous negotiations that went on until mid 2002 it was finally agreed that eight four-digit HS chapter sub-headings would ‘benefit from’ a more restrictive 45 percent maximum import content. This is subject to reconsideration under the mid term review of the Trade Protocol.

Several justifications were provided for such strict rules. Most were based simply on the desire to protect existing or potential industries against the possibility of increased competition arising from the freer trade in the region. This insurance was often unnecessary and misguided, not only because it violated the intention of using the Trade Protocol to promote freer trade in SADC, but also because the members in question had no significant local industry to protect anyway.²¹

A variation on the same argument is the fear that trade liberalization will lead to a flood of imports from new ‘screwdriver’ industries set up in neighboring countries to take advantage of the Trade Protocol. These concerns ignore specific prohibitions set out in the Protocol against the granting of preferential tariff treatment for screwdriver assembly activities.

A variety of other arguments based on safety, environmental protection and the possibility of dumping have been presented in particular cases as well. Without questioning the importance of achieving

²¹ In one instance in which a Member State pressed for restrictive rules of origin it turned out that the industry in question comprised only two firms. One was an internationally competitive exporter and had no need for or interest in a restrictive rule of origin. The other firm, a high cost import substitution producer, had already gone out of business – apparently unbeknownst to the country’s negotiators. In another such sector the firm that allegedly needed protection through a restrictive rule of origin had already received an offer of a government-funded investment grant covering almost 100 percent of its capital costs and had not yet even located a piece of land on which to build.

these social and economic goals, it is clear that rules of origin are not an appropriate instrument. In fact, the use of SADC rules of origin for these purposes would be very costly and almost certainly ineffective.²²

There are many types of industries and firms represented in these sectors. These include a significant and growing number of successful exporters. There is intra-industry trade – trade in middle products – within the region as well as exports in a variety of niche markets to various parts of the world, including Europe and North America. Extra-regional exports account for a growing share of production. Many of these are ‘new exports’ that have become more competitive due to MFN-based trade liberalization in the region over the past decade. What were once inward-looking import substitution industries have become global players. This has generated many new regional jobs – far more than can be created in uncompetitive import substitution activities.

Boxes 3 and 4 give examples of the sourcing practices in two sectors, water valves and small electric appliances, which have become competitive exporters as a result of liberalization of the South African economy over the past decade. Although their experience with international sourcing has been quite different, both provide important lessons for the design of rules of origin.

3. ROO and Internationally Competitive Exporters: Valves

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

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

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

Source: Case study interviews. See Flatters 2002b.

4. ROO and Internationally Competitive Exporters: Electric Appliances

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

Exporting is a tough business. Exporters of electric appliances prefer to source components locally, but only if price, quality and terms of delivery meet international standards. The degree of local sourcing varies considerably across products. To remain competitive producers must have the flexibility to source anywhere in the world. Internationally branded vacuum cleaners exported to the Middle East use motors from Italy. Simple

²² See Box 2 of Flatters 2002b for a discussion of these dumping and safety issues with respect to the case of electric cable.

cord sets for kettles and other exports are sometimes sourced domestically and sometimes from as far away as China. *It is the flexibility to source from anywhere that permits exporters to remain competitive.*

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

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

Source: Case study interviews. See Flatters 2002b.

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

The more restrictive special rules for particular subheadings would be much more of a problem.

In almost all cases in which a more restrictive rule has been agreed or proposed, the amendments are in respect of goods that already are produced in the region, most usually in South Africa and/or Zimbabwe (until the recent troubles). In most cases it is SACU that has proposed the alternative, more restrictive rule.

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

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

Producers would not voluntarily engage in cost-raising methods of production unless government policies required it and/or unless they were given some financial incentives for doing so. Assembly of products from CKD kits for sale in a protected domestic market is an example of a cost-raising activity encouraged by high tariffs on final products and lower tariffs on kits and components.²³

Of course, not all increases in local content raise costs. To be able to compete, whether in the local or international market, producers actually would prefer to be able to source raw materials and inputs locally (recall the lessons from Southeast Asia discussed earlier). But to remain competitive, they also must have the flexibility to obtain such materials from the best sources.²⁴

When high levels of local content are motivated by cost savings and by efficient production, existing producers have nothing to fear from competitors that might set up operations with lower levels of local content in other member states. Even if changing technology or new marketing possibilities make lower local content production methods more competitive, existing producers are better placed to adjust than new competitors.

²³ See Box 7 in Flatters 2002b on refrigerator production in Mauritius for a good example of this.

²⁴ The agreed rules now include as well a requirement for the local assembly (‘population’) of printed circuit boards (PCBs) in television receivers and video monitors. There is no obvious justification for such a requirement in order to prevent trade deflection. If local population of PCBs makes economic sense (i.e. is less costly than importing already assembled boards), then self-interested actions of profit seeking producers will ensure that this happens. But if it is less costly to import than to assemble PCBs, there is no economic argument for using SADC rules of origin to encourage such assembly.

The chapter rule requiring 40 percent local content is sufficient to authenticate origin of manufactured goods in these chapters. Additions to these requirements are at best unnecessary, and at worst will inhibit intra-SADC competition and make SADC irrelevant for producers that are or wish to be internationally competitive.

Two member states have recently proposed that the chapter rule be relaxed in favor of one that is *less* restrictive for a number of industries in which they hope to attract export-oriented investors. This recognizes that international competitiveness rests on flexibility in sourcing of raw materials, not on the imposition of arbitrary barriers such as restrictive rules of origin.

5.3 Textiles and Garments²⁵

Textiles and garments are of particular interest in SADC. This is one of the few manufacturing sectors in which there is significant production in a number of member states. Differences in labor intensity and other determinants of comparative costs at various stages in the textile and garment 'value chain' also mean that there are potentially significant complementarities among member states which could enhance the region's competitiveness in world markets. It is a sector in which some member states, most importantly Mauritius, have already demonstrated the potential of the region. The opportunities opened up through the Africa Growth and Opportunities Act (AGOA) together with the looming uncertainties arising from the end of the Agreement on Textiles and Clothing (ATC) make this a crucial time for remedying domestic and regional policy weaknesses.

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

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

As currently agreed, the movement to SADC free trade in textiles and garments will be slow and there are relatively complex transitional arrangements. Most non-SACU Member States have postponed significant tariff reductions until very late in the transition process. Even SACU has postponed full tariff liberalization in this sector until 2005 (and even later in the case of clothing).²⁶

With a few exceptions and except for yarn, the rules of origin require double transformation in order to qualify for SADC tariff preferences – garments must be made from regionally produced textiles; fabric must be made from regionally produced yarns; yarn must be made from uncarded, uncombed fibre or from chemical products. The double transformation rules for garments and fabric are waived for the four poorest member states, Malawi, Mozambique, Tanzania and Zambia (known as the MMTZ countries), on exports to SACU, but only until July 2006, and subject to small quotas. It was agreed early on that this derogation and its phase-out would be reassessed as part of the mid term review of the Trade Protocol.

²⁵ This section draws heavily on Flatters 2002a.

²⁶ South Africa has recently proposed an acceleration of the tariff phase down in these sectors, conditional on similar actions by other member states. However, it must be noted that the sector will remain constrained by SADC's very restrictive two stage transformation rule of origin requirement.

The current SADC rules of origin will be very difficult to satisfy for most regional garment producers.

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

Even in South Africa the vast majority of garment producers use imported fabric. When asked how it would respond to a requirement that its garments be made from domestic or regional fabric (i.e. to meet the SADC rules of origin), the owner of one of South Africa's most successful garment producers replied: "We could not compete; we would shut our doors tomorrow."²⁷ This is despite import duties of 40 percent on its products. Another manufacturer of brand name apparel uses Italian cotton fabric for its high end products. Such fabric cannot be obtained from a South African producer at any cost.²⁸ The same is true, and in fact even more so, of SADC garment makers outside of South Africa. This is not surprising in light of the much lower stage of development of upstream textile industries and the small scale of the domestic markets in most of SADC.

Enshrining in the Trade Protocol rules of origin that cannot be met even by South African garment producers arose in part from the structure of MFN tariff protection of this industry in SACU.²⁹ South African garment makers that sell in the domestic market and hence do not benefit from duty rebates or additional export incentives suffer from the cost-raising impact of high fabric import duties, generally in excess of 20 percent. At the same time, they are more than adequately compensated for this by much higher import duties on garments, generally in excess of 40 percent. The net effect is very high rates of effective protection when selling domestically.

As long as they are penalized by high duties and other restrictions on yarn and fibre imports, South African textile makers do not want duty-free competition from regional weaving and knitting industries that have access to duty free yarn. Similarly, South African garment makers do not wish to compete with those in other Member States that do not suffer the cost-raising effects of high tariffs on fabric. A double transformation rule of origin 'solves' this problem by ensuring that such competition will never occur. The rule is designed, not to encourage use of regional textile inputs (not even South African garment makers do so at the moment), but rather, to ensure that SADC preferential trade does not take place when South African garment makers labor under the handicap of high domestic textile duties. The same explanation applies one stage further back in the production chain.

Since most South African producers cannot satisfy this rule of origin, it is highly unlikely that it could be met by non-SACU producers. The double transformation rule will prevent preferential intra-SADC garment trade, thus permitting South Africa to preserve its high protection policies on garments and fabric. It certainly will not promote intra-SADC trade in this sector – not even among non-SACU Member States. And it will do nothing to promote the global competitiveness SADC textile and garment producers.

The real challenge facing the SADC textile and garment industries is the expiry of the Agreement on Textiles and Clothing (ATC) at the end of 2004. The post ATC world will be one of ruthless competition, with competitive producers sourcing fabrics and other raw materials from the most economical sources. Market shares will no longer be determined by quota arrangements in rich country markets. They will depend solely on suppliers' abilities to compete on the basis of cost,

²⁷ Source: case study interviews.

²⁸ See Box 3 of Flatters 2002a.

²⁹ See Box 4 of Flatters 2002a.

quality and timeliness of delivery. Producers that are burdened by cumbersome Customs procedures and administrative requirements of dealing with restrictive rules of origin in regional markets will find it difficult to compete.

For export-oriented garment and textile production, any SADC rules of origin are redundant in the face of any restrictive rules imposed by AGOA and the EU and/or unnecessary and cost-raising where exports are not constrained by such rules in export markets.

The stringent rules of origin and back-loaded tariff reduction schedules that are currently agreed will be especially unhelpful to SADC as a means of taking advantage of US or EU preferences or adjusting to the challenges that will soon arise with the end of the ATC. They impede rather than promote the increased competitiveness that will be necessary to survive in the post-ATC world in 2005 and beyond.

6. General Observations

This paper has taken a 'bottom up' approach to rules of origin, looking at the details of a particular agreement and critically examining its likely effects against the claims put forth by stakeholders and decision-makers in the course of and subsequent to the negotiations. Arguments have been supported by qualitative and quantitative information obtained not only from verifiable market data but also from a variety of individual agents.

The methodology is quite different from most of the other papers. Before summarizing our main conclusions, we pause here to ask what light this work might shed on some of the other exercises conducted under this project, especially the construction and use of various summary indices of rules of origin regimes as exemplified by the pioneering work of Estevadeordal (2000) and Estevadeordal and Suominen (2003) and built upon by a number of the other papers.

6.1 Constructing and Interpreting an Index

To construct an overall index of restrictiveness of the SADC rules of origin regime would not have revealed almost all of the useful insights and information that have come from our own work on SADC. Further it would not be very helpful in guiding or persuading decision-makers in developing, evaluating or contemplating changes in the regime.

Nevertheless, it is useful to identify simple summary measures of complex phenomena. The concept and measurement of national income has been one of the greatest and most useful simplifications in economics. Trade policy analysis is replete with indices of the average levels (and variances) of nominal and effective protection provided by tariffs. While there are issues about whether to use trade, production or other weights, the concept of a tariff rate is at least quite well founded. A 10 percent tariff can generally be interpreted in terms of the magnitude of an important economic variable, the distortion between domestic and international prices.

The quantification of non-tariff barriers such as import quotas and other quantitative restrictions is more difficult, but has had real usefulness when the restrictions are conceptualized in terms of their tariff or subsidy equivalents.

Rule of origin are more difficult still. The approach taken by Estevadeordal is to classify rules of origin according to their administrative types, make prior assumptions about the restrictiveness of each type and assign an index of between 1 and 7, in order of increasing restrictiveness to each type.

A change of tariff heading rule is assumed to be more restrictive than a change of sub-heading. This is certainly a plausible assumption. However, as Estevadeordal and Suominen observe, the HS coding system was not designed as a policy implementation tool for rules of origin. As experience in SADC and other PTAs has shown, a change of chapter requirement in most agricultural or primary commodities might be much easier to meet than even a change of sub-heading in some chemical,

electrical or mechanical goods sectors where inputs and outputs are often included in the same sub-heading.

While tariff chapters versus sub-headings might seem to be relatively simple, what about technical and value requirements? Is a technical requirement more or less restrictive than a restriction on import content? And if there are both a technical and value content requirement in a sector, is that more restrictive than having just a technical requirement or just a value requirement? Clearly, the answer depends at least in part on the nature of the technical requirement and on the amount of import content allowed under the value requirement. And when there are two requirements, the answer depends on which one is binding for producers or potential regional exporters in the sector.

And once again the restrictiveness of any given requirement will vary according to the sector in which it is applied (compare instant coffee, valves and electrical goods described in Boxes 1, 3 and 4 above). The Estevadeordal index makes no allowance for such differences and in fact does not distinguish among different levels of permissible import content at all. All other things equal, a 60 percent local content requirement gets the same restrictiveness index as a 35 percent requirement. Some of the most heated discussions in SADC have been precisely over issues such as this. Yet according to this index, they do not matter.

What then do we make of measures of inter-sectoral variances of the restrictiveness index? Once again it surely depends on the details. One thing that is certain is that the imposition of uniform rule of origin requirements across sectors will ensure differences in their restrictiveness across these sectors. The question becomes whether variations in rule of origin requirements across sectors increase or decrease the degree of restrictiveness of the regime, by sector or overall.

The SADC negotiations offer a number of interesting examples. In HS 84, for instance, South Africa started by proposing a uniform and highly restrictive value content requirement as a chapter rule, to which in some sub-headings was added a technical requirement that printed circuit boards (PCBs) be populated in the region. Faced with an attack on the chapter rule, the response was to slowly agree to less stringent value requirements and removal of the technical requirement in sectors 'of no importance' to South Africa (i.e. in which there was no local production). This has eventually led to a less restrictive chapter rule with exceptions for all the sectors of interest to South Africa. In these sectors the required value content remains high (but subject to reconsideration under the Mid Term Review of the Trade Protocol). The result has been a reduction in the restrictiveness of the chapter rule, an increase in its variance, and no change in its real restrictiveness.

The variance in type and level of rule of origin requirements across many sectors in SADC can be described in a similar way. In sectors of interest to a major player (usually South Africa) rules were adjusted to ensure maximum protection against new preferential imports arising from SADC tariff liberalization. In sectors of no interest to South African producers, less stringent rules were often agreed. The result is high variance and a highly restrictive regime.

A quick and admittedly superficial examination of the rules in the new US FTAs with Chile and Singapore, on the other hand, suggests that, except for textiles and garments, variance in the rules (change of chapter versus change of sub-heading, etc.) reflects an attempt to remove some of the unnecessary restrictiveness that would result from application of a uniform rule. This appears to be the case at least in sectors that have been particularly contentious in the SADC negotiations. Despite their high variance, a substitution of US-Chile or US-Singapore rules for those in SADC would almost surely reduce the restrictiveness of the SADC regime.

Estevadeordal and Suominen (2003) place the US-Chile and US-Singapore rules in the same category as NAFTA's. This is consistent with US public pronouncements on the new regimes. However, based again on a less than complete examination of all the details, these new FTAs would appear to have less restrictive rules than NAFTA. The value content requirements certainly tend to be less in the bilaterals than in NAFTA. However, this is not regarded as important in the Estevadeordal index.

None of this is meant to cast undue aspersion on the Estevadeordal index or its use by Estevadeordal and Suominen. Indeed the information provided in this exercise is of enormous value. But any attempt to summarize a complex reality by a few numbers is bound to lose a great deal of the information that went into its construction. An important lesson from SADC is that a great deal of the most interesting information is in the details of the rules and their effects in different sectors. This points to the importance of undertaking work on specific sectors-the case study approach and would caution against relying solely on aggregate or average measures of protection³⁰.

6.2 Political Economy and Other Elements of Trade Policy

The SADC rules of origin are the result primarily of the influence of special interests and a lack of understanding of the economic consequences. We concentrate here on self interest.

Implementation of the SADC Trade Protocol will lead to the eventual removal of most import tariffs on intra-SADC trade. This has the potential to erode protection of producers in members' domestic markets. It also opens opportunities for preferential access to regional markets. Rules of origin can protect against domestic preference erosion by making it impossible, or at least very costly to take advantage of PTA preferences. They can also be used to keep out unwanted competition in regional markets. As the examples in earlier sections have shown, this is clearly a large part of the story in the negotiation of SADC rules of origin.

Rules of origin work in conjunction with members' MFN tariff structures and possibly with other elements of the trade policy regime as well. They are more important the greater are the levels of tariffs in the PTA and the greater are their differences among members, especially on inputs. A rule of origin that might otherwise be very restrictive will have little impact in the absence of significant MFN import tariffs.

This has some interesting implications.

It suggests an alternative way of quantifying the restrictiveness of a rule of origin – i.e. to estimate the effective protection that producers would face in PTA markets with and without that rule, with the rule's restrictiveness indicated by the increase in effective protection due its imposition. Such estimates are mentioned in a number of the SADC cases discussed earlier³¹. It is analogous to the quantification of the tariff or subsidy equivalents of other non-tariff trade barriers. This would dispense with the need for arbitrary assumptions about the restrictiveness of different types of administrative requirements and would provide a way of examining different effects of similar rules in different sectors.

It suggests as well that any attempts to measure the effects of rules of origin without reference to the tariff structure and other elements of the trade policy regime are likely to be very seriously misspecified. This is true in looking at behavior both within and across different PTAs. Estevadeordal and Suominen (2003), for instance, report on an examination of the effects of rules of origin on trade in intermediate goods in the motor industry. The model includes no trade or industrial policy variables other than rules of origin. This an industry that is known in many places to be riddled not only with complex tax and tariff structures but also long legacies of local content requirements and other incentives. South Africa's Motor Industry Development Program (MIDP), for instance, has recently replaced a set of cumbersome and costly local content rules with export subsidy programs based on the granting of import privileges on vehicles and components in an otherwise heavily

³⁰ This finding mirrors the argument of economists that argue for firm level analysis of effective protection rather than relying on Social Accounting Matrices. Analyses based on average rates of protection will underestimate the level of protection since they smooth out the effects of the tariff peaks. Almost invariably import substituting activities will produce items with higher than average rates of duty rather than lower than average.

³¹ A firm level survey of effective protection throughout SADC supported this finding. See SADC Economic Impact Assessment Study, TSG, September 30, 2003

protected market.³² An attempt to explain trade in vehicles and components in South Africa without consideration of these complex incentives would certainly be misspecified.

Returning to the more general link between rules of origin and MFN tariff structures and the case of SADC, there can be little doubt that a major effect of this regime's restrictive rules of origin will be to maintain protection and trade patterns that might otherwise be eroded by intra-SADC free trade. While there has been some talk about development of inter-regional linkages between upstream and downstream industries and especially about using SADC rules of origin to promote the development of upstream trade linkages, this is mostly rhetoric hiding some combination of self-interest in and ignorance of the true effects of the rules.

6.3 Harmonization of Rules of Origin

Estevadeordal and Suominen (2003) use their indices to characterize different rule of origin regimes around the world. Among their interesting findings is a convergence of many of them towards two main types – the PANEURO and the NAFTA models. There is then a suggestion that this *de facto* convergence might and arguably should be encouraged to be translated into some kind of *de jure* convergence at the global level.

There can be little economic argument against some disciplines on the application of restrictive rules of origin in PTAs. However, caution should be exercised in advocating either the PANEURO or the NAFTA type of regime as the model. Use of these models in preferential agreements involving developing countries would be a serious setback to global trade liberalization.

Just as the restrictiveness of similar rules varies across sectors in any country, similar rule of origin regimes among countries and regions at different economic levels will not have a symmetric impact. This is especially true in key manufacturing sectors in which poorer countries might expect to begin to participate in the global division of labor. As the experiences of Southeast Asia and Mauritius have shown, international fragmentation of production enables poorer countries to participate in particular stages of the process. But requiring them to engage at the same time in stages in which they do not yet have technological capabilities or relative cost advantages would cripple their ability to participate.

On the basis of our investigations, it is apparent that adoption of the PANEURO model as the basis for the rules of origin in SADC will doom this PTA to failure. There is circumstantial evidence that imposition of some NAFTA-type rules in AGOA and of PANEURO rules in economic partnership agreements (EPAs) that are now under negotiation between the EU and ACP countries are having or will have similar effects.³³

If Estevadeordal and Suominen (2003) are correct about the current convergence towards the PANEURO and NAFTA models, the correct focus of attention should be radical reform of rules of origin regimes, and not on harmonization. It is necessary to get back to basics, to consider the effects of alternative rules of origin in light of their only necessary function and to discard their use for protection and other distorting and counterproductive uses. Failure to do so will doom regionalism to the fate of its greatest critics.

Policy researchers could help by building on the information assembled by Estevadeordal and Suominen and others, not just by running global or regional regressions on questionable data and crude indices, but also by examining and documenting how rules of origin actually work. Discussions are now under way in various policy fora; investments in research of this type might have a high rate of return.

³² See Flatters 2002c and Flatters 2003.

³³ See Brenton 2002 and Mattoo *et al* 2002.

7. Conclusion

Rules of origin are necessary in preferential trading arrangements. However, they are needed for only one reason, to authenticate that the goods claiming preferences are the product of significant economic activity in a participating member state. The originally agreed rules in the SADC Trade Protocol would have achieved this purpose without imposing any significant unintended distortions on private production or investment decisions.

Before the Trade Protocol was implemented, however, the rules were tightened. The stated goal was to use rules of origin to encourage the development of linkages between upstream and downstream industries. This strategy, however, is based, at least implicitly, on a development model that is contrary to evidence from recent experience in Asia and Africa and that has failed in many places.

Global commerce is characterized by large volumes of trade in middle products. This facilitates 'fragmented' production to take advantage of differences in economic circumstances across locations. To interfere in this process through local content regulations or restrictive rules of origin is a dangerous form of protectionism. It raises the costs of participating in the global production and trading system. It is an invitation for investors to go elsewhere.

The idea of developing clusters of linked industries and activities through rules of origin has a superficially appealing plausibility. Accepting these arguments without question is encouraged by vocal stakeholders with a vested interest in the protection the rules provide. And it is further reinforced by the appeal to existing models, especially those provided by the EU in a variety of trade arrangements with developing countries.

To impose restrictive rules of origin in a large and technologically sophisticated market such as the EU is one thing. However, the entire SADC market is smaller than Turkey and its industrial structure is still thin and undiversified. To burden SADC producers with the constraints of such rules in this market is not a sensible development strategy. The best it can do is to make SADC irrelevant as a tool for increasing the participation of its members in world markets.³⁴

The tendency to expand the scope of rules of origin beyond their simple task of authentication is one of the major flaws of regionalism and other types of preferential trading arrangements as approaches to global trade and investment liberalization.

³⁴ See Flatters 2001 for further discussion.

References

- Brenton, Paul 2003 “The Value of Trade Preferences: The Economic Impact of Everything But Arms” Washington DC: The World Bank *mimeo*.
- Coughlin, Peter, Musa Rubin and L. Amedée Darga 2001 *The SADC Textile and Garment Industries, Constraints & Opportunities, Myopia or Global Vision?* Study Commissioned for Southern Africa Development Community, Gaborone, August
- Cheng, Leonard K. and Henryk Kierzkowski 2001 *Global Production and Trade in East Asia* Norwell MA: Kluwer Academic Publishers
- Erasmus, Hennie and Frank Flatters 2003 “Rent-Seeking in Regional Trade Liberalization: Rules of Origin and Other Barriers to Trade in Wheat and Wheat Products”
<http://qed.econ.queensu.ca/faculty/flatters/main/writings.html>
- Estevadeordal, Antoni 2000 “Negotiating Preferential Market Access: The Case of the North American Free Trade Agreement” *Journal of World Trade* 34, 1 February
- Estevadeordal, Antoni and Kati Suominen 2003 “Rules of Origin: A World Map and Trade Effects” paper prepared for the workshop “The Origin of Goods: A Conceptual and Empirical Assessment of Rules of Origin in PTAs” INRA-DELTA, Paris, May
- Flatters, Frank 2001 “The SADC Trade Protocol: Impacts, Issues and the Way Ahead”
<http://qed.econ.queensu.ca/faculty/flatters/main/writings.html>
- Flatters, Frank 2002a “Rules of Origin and AGOA: Hard Choices for Textiles and Clothing in SADC”
<http://qed.econ.queensu.ca/faculty/flatters/main/writings.html>
- Flatters, Frank, 2002b “SADC Rules of Origin: Undermining Regional Free Trade”
<http://qed.econ.queensu.ca/faculty/flatters/main/writings.html>
- Flatters, Frank, 2002c “From Import Substitution to Export Promotion: Driving the South African Motor Industry” <http://qed.econ.queensu.ca/faculty/flatters/main/writings.html>
- Flatters, Frank, 2003 “Is the MIDP a Model for Selective Industrial Policies?”
<http://qed.econ.queensu.ca/faculty/flatters/main/writings.html>
- Jones, Ronald W. and Henryk Kierzkowski 1990 “The Role of Services in Production and International Trade: A Theoretical Framework” In R.W. Jones and A. Krueger eds. 1990 *The Political Economy of International Trade* Oxford: Basil Blackwell
- Jones, Ronald W. and Henryk Kierzkowski 2001a “Globalization and the Consequences of International Fragmentation” in R. Dornbusch, G. Calvo, and M. Obstfeld eds. *Money, Factor Mobility and Trade: The Festschrift in Honor of Robert A. Mundell* Cambridge MA: MIT Press
- Jones, Ronald W. and Henryk Kierzkowski 2001b “A Framework for Fragmentation” in S. Arndt and H. Kierzkowski *Fragmentation: New Production Patterns in the World Economy* Oxford: Oxford University Press
- Jones, Ronald W. and Henryk Kierzkowski 2001c “Horizontal Effects of Vertical Fragmentation” ch.3 in Cheng and Kierzkowski 2001
- Mattoo, Aaditya, Devesh Roy and Arvind Subramanian 2002 “The Africa Growth and Opportunities Act and its Rules of Origin: Generosity Undermined?” IMF Working Paper WP/02/158
- Meade, J.E. 1964 *Efficiency, Equality and the Ownership of Property* London: G. Allen and Unwin
- Moran, Theodore H. 2001 *Parental Supervision: The New Paradigm for Foreign Direct Investment and Development Policy* Analyses in International Economics 64, Washington DC: Institute for International Economics

Sanyal, Kalyan K. and Ronald W. Jones 1982 “The Theory of Trade in Middle Products” *American Economic Review* 72, 16-31

Stern, Matthew and Nnzeni Netshitomboni 2001 “Africa Growth and Opportunities Act: Hot Air or Hot Stuff?” <http://www.tips.org.za/research/papers/getpaper.asp?id=495>

TSG, SADC Economic Impact Assessment Study, September 30, 2003, prepared under USAID project PCE –I-98-00017-00 TO823.