

Rules of Origin and SADC:

The Case for Change in the Mid Term Review of the Trade Protocol

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Abstract

Rules of origin are a key factor determining whether trade agreements meet their objectives. In the case of SADC, the rules go beyond their function of preventing transshipment of products from third countries, to protect existing industries from increased intra-regional competition. Rather than facilitating development through trade, the SADC Trade Protocol replaces transparent and declining tariff barriers in important sectors with complex and more restrictive input sourcing requirements that will diminish trade, increase transactions costs, reduce flexibility of producers and make the region a less attractive place to invest. This paper discusses how a movement towards simple and transparent rules of origin, which are easier to administer and with which it is easier to prove compliance, is likely to stimulate regional integration and facilitate the growth of companies that are able to compete effectively on global markets.

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Executive Summary

Rules of origin are essential elements of preferential trade agreements to ensure that only eligible products receive tariff preferences. But, the way that the rules of origin are designed and implemented will have profound implications for trade flows and the extent of regional integration. Rules of origin are a key factor determining whether trade agreements meet their objectives. The basic conclusions from the literature on rules of origin that has developed in the past few years are that:

- Specifying simple, generally applicable rules of origin, with a limited number of clearly defined and justified exceptions, is appropriate if the objective is to stimulate economic integration. Unnecessary use of a detailed product-by-product approach to rules of origin is likely to lead to complex and restrictive rules of origin and to constrain integration.
- Restrictive rules of origin constrain international specialization and discriminate against small low-income countries where the possibilities for local sourcing are limited. Simple, consistent and predictable rules of origin are more likely to foster the growth of trade and development.
- Rules of origin that vary across products and agreements add considerably to the complexity and costs of participating in and administering trade agreements. The burden of such costs fall particularly heavily upon small and medium sized firms and upon firms in low-income countries. Complex systems of rules of origin add to the burdens of Customs and may compromise progress on trade facilitation.
- In the globalized world market of today simple rules of origin are more likely to stimulate trade and investment in the region by providing producers with flexibility in sourcing their inputs without compromising the ability to prevent transshipment of goods from third countries which are not members of the agreement.

In the case of SADC, a major step away from the initially proposed simple rules of origin was taken and a set of more detailed and product specific rules are being applied, similar to those of the EU and as applied in the EU-South Africa free trade agreement. These rules go beyond what is necessary to prevent transshipment of products from third countries to act to protect existing industries from increased intra-regional competition. Rather than facilitating development through trade, the Trade Protocol will replace transparent and declining tariff barriers in important sectors with complex and more restrictive input sourcing requirements that will diminish trade, increase transactions costs, reduce flexibility of producers and make the region a less attractive place to invest.

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

By permitting increased flexibility and reducing transactions costs, they can only help them.

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

Initial indications suggest that the direct impact of the SADC Trade Protocol has been very limited. Intra-regional trade in products which do not receive preferences has grown much faster than trade in products which are eligible for preferential treatment. The rules of origin are likely to be one of the key constraints on the take-up of the available preferences. Many of the arguments that were used to support the use of product-specific and restrictive rules of origin can now be seen to have been misplaced and information obtained from many firms and sectors that were initially thought to need restrictive rules actually suggests that they would now prefer less restrictive and less costly rules.

Thus, more simple rules of origin which provide producers with flexibility in proving compliance, backed up by training of customs officials and better information for traders is likely to contribute towards more effective enforcement of rules of origin whilst at the same time facilitating legitimate preferential trade and integration within SADC. An appropriate approach would be to supplement the existing rule which ensures that simple screwdriver assembly operations do not confer origin and the standard rule relating to wholly produced goods (those that have no import content at all) with common rules across all products relating to the requirements for goods produced with some imported inputs that they either

- undergo a single change of tariff heading, *or*
- contain non-SADC imported materials worth no more than 65 percent of the net cost of the good (a regional content of 35 percent of net cost) or no more than 60 per cent of the ex-works price of the good (regional content of 40 percent).

If these suggestions are difficult to implement in the short-run there are substantial improvements that can be made to the existing product specific rules of origin to reduce the restrictiveness of these rules. A review should also be undertaken of the scope for the introduction of exporter self-certification for known reliable exporters which would ease the burden on firms in proving compliance with the requirements of the rules of origin.

With movement towards a simpler system which is easier to administer and with which it is easier to prove compliance, the trade protocol is more likely to stimulate regional integration and facilitate the growth of companies that are able to compete

effectively on global markets. Such a move would also bring SADC into line with other agreements amongst developing countries and the more general trend towards liberalisation of rules of origin in preferential trade agreements.

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Rules of Origin and SADC: The Case for Change in the Mid Term Review of the Trade Protocol

1. Introduction

Rules of origin are a major factor determining whether preferential trade agreements achieve their objectives. Rules of origin are necessary to identify products that qualify for SADC tariff preferences and so ensure that only goods originating in participating countries enjoy such preferences. When a product has no import content the necessary rule is trivial. This is the case for many basic agricultural products. However, in a world of specialisation and globalisation, parts of the production process of many products are undertaken in various locations. The rules of origin then must specify what level of processing in the partner is sufficient to confer origin and preferential access.

It has become increasingly recognized that rules of origin can be, and often are, manipulated to try and achieve objectives other than that of identifying the nationality of a product. Often countries seek rules of origin which limit the impact of a preferential trade agreement on domestic firms. This seems to be particularly the case in trade agreements between large industrial countries and smaller developing countries, such as in the Cotonou Agreement between the EU and the ACP countries and in the NAFTA. A country may also seek rules of origin which stimulate local intermediate goods producers by encouraging their partners to switch away from inputs imported from non-members. Rules of origin have also been seen as a means for achieving development objectives of supporting infant industries and encouraging more domestic value-added.

In all of these cases the desire is to adopt rules of origin that are more restrictive than is necessary to simply prevent transshipment of goods from third countries which are not members of the agreement. The higher the level of processing that is required in the partner the more difficult it will be for the partner's products to receive trade preferences, especially if the partner is a small low-income, low-wage economy. Further, restrictive rules of origin not only affect trade within a region but also the ability of local firms to participate in global trade networks. Thus, the nature of the rules of origin can act to undermine the stated intentions of preferential trade agreements to stimulate regional trade but also to compromise broader trade objectives.

It is in the context of an increasing literature and understanding of the potential impacts of rules of origin that this paper reviews the rules currently applied under the SADC trade protocol. The review is particularly pertinent since the EU has also undertaken a fundamental review of its own rules of origin, recognizing that they have compromised its own development objectives. The rules of origin adopted by SADC bear a strong similarity to those of the EU and indeed appear to have been strongly influenced by them through the influence of the EU-South Africa free trade agreement.

In addition to the impact of the rules of origin on producers it has also become apparent that the nature of the rules of origin have important implications for those charged with administering the trade rules, especially customs. In general the more complex the

rules that have to be administered the greater the burden on customs. Increasing the burden on customs may well in turn reduce processing times at the border and compromise objectives with regard to trade facilitation.

This paper reviews the rules of origin being currently applied in SADC in the light of the increasing experience and literature on rules of origin and on the basis of consultations with firms in the key sectors influenced by the rules that have been adopted. On the basis of this analysis we conclude that a move to a more simple set of rules of origin that are easier for firms and customs officials to apply and that allow firms the flexibility in sourcing inputs that they need to be globally competitive is more conducive to increasing trade, growth and development in the SADC region. We start by briefly reviewing the key conclusions that have emerged from the growing literature on preferential rules of origin and their impact. The second part of the paper looks more specifically at the rules of origin in SADC and draws out some lessons for the review of the Trade Protocol from the initial years of their implementation.

2. What Type of Rules of Origin?

2.1 Defining Origin

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

The purpose of rules of origin is to prevent trade deflection, to ensure that only goods produced in PTA members qualify for PTA preferences. Rules of origin specify the necessary conditions for goods to be considered to have been produced in a qualifying member country. All rules of origin, including those in SADC, include a general provision specifying that very simple operations, such as, repackaging, relabelling, simple mixing and assembly and other 'screwdriver' operations are not sufficient for products to qualify as regionally produced for the purpose of obtaining tariff preferences. For cases in which two or more countries have taken part in the production of the good, the rules of origin define the methods by which it can be ascertained in which country the particular product has undergone sufficient working or processing or has been subject to a substantial transformation. A substantial transformation is one that conveys to the product its essential character. Unfortunately, there is no simple and standard rule that can be identified as identifying the 'nationality' of a product. Box 1 describes the three main types of rules which are applied to decide the origin of a product.

Box 1: Methods for Determining Sufficient Processing or Substantial Transformation

Change of Tariff Classification. Origin is granted if the exported product falls into a different part of the tariff classification to any imported inputs that are used in its production. The change of tariff classification rule, once defined, is clear, unambiguous, and easy for traders to learn. It is relatively straightforward to implement. In terms of documentary requirements it requires that traders keep records that show the tariff classification of the final product and all the imported inputs. There is, however, the issue of the level of the classification at which change is required. The higher the level of the classification at which change is required the more difficult it is to satisfy the rule. Typically it is specified that the change should take place at the heading level (that is at the 4-digit level of the HS).¹

Value Added. When the value added in a particular country exceeds a specified percentage, the goods are defined as originating in that country. This criterion can be defined in two ways, i.e., either as the minimum percentage of the value of the product that must be added in the country of origin or as the maximum percentage of imported inputs in total inputs or in the value of the product. As in the case of change of tariff classification, the value added rule has the advantage of being clear, simple, and unambiguous in its definition. However, in actual application the value added rule can become complex and uncertain. First, there is the issue of the method of calculation. Different methods will have different implications for origin determinations. Second, the application of this method can be costly for firms who will require sophisticated accounting systems and the ability to resolve often-complex accounting questions. Finally, under the value added method origin is sensitive to changes in the factors determining production cost differentials across countries such as exchange rates, wages and commodity prices. For example, operations that confer origin in one location may not do so in another because of differences in wage costs. An operation that confers origin today may not do so tomorrow if exchange rates change.

Specific Manufacturing Process. This criterion delineates for each product or product group certain manufacturing or processing operations that define origin (positive test) or manufacturing or processing procedures that do not confer origin (negative test). The formulation of these rules can require the use of certain originating inputs or prohibit the use of certain non-originating inputs. For example, EU rules of origin for clothing products stipulate, “manufacture from yarn,” whilst the rule for tube or pipe fittings of stainless steel stipulates “turning, drilling, reaming, threading deburring and sandblasting of forged blanks”. The main advantages of specific manufacturing process rules is that once defined they are clear and unambiguous so that from the outset producers are able to clearly identify whether their product is originating or not. However, there are also a number of drawbacks with this system including obsolescence following changes in technology and the documentary requirements, such as an up-to-date inventory of production processes, which may be burdensome and difficult to comply with.

No one rule dominates others as a mechanism for formally identifying the nationality of all products. Each has its advantages and disadvantages.

2.2 Rules of Origin and Competitiveness

The details of the specific rules and especially the amounts of local processing or input use required are very important. From a long term developmental perspective, to ensure the international competitiveness of PTA producers in the global economy, it is

¹ Examples of simple HS headings are: ‘Beer made from malt’ (HS 2203) and ‘umbrellas and sun umbrellas’ (HS 6601). An example of a more sophisticated heading would be: ‘Machinery, plant or laboratory equipment, whether or not electrically heated (excluding furnaces, ovens and other equipment of heading 8514), for the treatment of materials by a process involving a change of temperature such as heating, cooking, roasting, distilling, rectifying, sterilizing, pasteurizing, steaming, drying, evaporating, vaporizing, condensing or cooling, other than machinery or plant of a kind used for domestic purposes; instantaneous or storage water heaters, non-electric’ (HS 8419).

critical that rules of origin do not unnecessarily restrict the flexibility of regional producers in sourcing of inputs and raw materials.

One of the most important features of the globalization of economic activity in recent decades has been the ‘delocalization’ or ‘fragmentation’ of global manufacturing. Enormous improvements in transportation, communication and logistics have made it possible for the manufacture of almost all goods to become truly internationalized.² A key to successful economic development in these circumstances has been to create conditions in which local producers can participate in any and all stages of the resulting international value chains. But effective participation in this process requires ease of import and export and maximum flexibility in sourcing of inputs and raw materials. This is especially true for poorer countries that have not developed the sophisticated and diversified production bases that are sometimes achieved at higher levels of development.³ Overly demanding or complex rules of origin are a serious impediment to development in such a world. They restrict firms in their global sourcing decisions and they erect costly administrative barriers to international trade. Inappropriate rules of origin can be a major barrier to a region’s international competitiveness.

Prevention of trade deflection requires not only appropriately defined rules of origin, but also proper administration of these rules. The dangers of trade deflection are greatest in PTAs with wide variations in MFN tariff structures among its members. In such PTAs stakeholders are often heard to call for ‘strong’ rules of origin often in response to the (mis)perception of the threat of a flood of illegal cheap imports from Asia. ‘Strong’ rules of origin need to be interpreted as rules that are easily and properly enforced, not rules that are unduly restrictive or costly to comply with, see Box 2.

² See Arndt and Kierzkowski 2001 and Cheng and Kierzkowski 2001, for instance.

³ Mauritius is a classic (SADC) example of a country that has utilized trade in this way to escape from what once appeared to be an iron grip of poverty. For an excellent description of the problems faced at independence see Meade 1964 and for a brief summary of what has been achieved through effective participation in the global economy see section 2.2.2 of Flatters and Kirk 2004.

Box 2: ‘Strong’ versus ‘Weak’ Rules of Origin

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

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

A ‘strong’ customs regime is one that can effectively enforce customs laws at minimal cost to the government and to legitimate importers and exporters. One hundred percent inspections and the imposition of long and arbitrary delays are signs of a weak customs administration, relative to one that can enforce customs laws with well designed risk assessment procedures and speedy processing of imports and exports. Excessively restrictive rules of origin and costly administrative procedures to enforce them undermine the purposes of a preferential trade agreement. They are a sign of weakness, not strength.

2.3 The Costs of Restrictive Rules

Awareness of the importance of rules of origin in determining the trade impact of preferential agreements has increased as such agreements have become subject to increased scrutiny. EU rules of origin have been criticized for limiting the benefits of non-reciprocal preferences under the GSP and Cotonou agreements. For example, under the EU’s Everything But Arms Agreement (EBA) for the least developed countries (part of the GSP), which offers duty free access for all products, only about 50 per cent of the preferences available to non-ACP countries are actually utilized.⁴ Rules of origin lie at the heart of this under-utilisation of preferences since most of these countries specialize in the production of clothing products for which EU rules of origin are restrictive, requiring production from yarn. These rules of origin are a fundamental reason why EU preferences under both the GSP and the Lome and then Cotonou agreements have done little to stimulate the clothing sector in Africa. One justification for such restrictive rules has been to encourage an integrated textiles/clothing sector in Africa. However, in practice these rules have done nothing to stimulate an efficient textile sector and have seriously constrained the growth of the clothing sector in many, particularly small, African countries.

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

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

⁴ See Brenton (2003). The non-ACP countries can only export under the EBA. ACP countries can choose to use the Cotonou agreement. In fact most exports from ACP countries enter the EU under Cotonou rather than the EBA- one reason may be that the cumulation provisions under Cotonou are more extensive.

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

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

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

AGOA has had a profound impact on the exports of a small group of sub-Saharan African countries, almost entirely as a result of the provisions regarding clothing.⁵ All of the countries that have been able to substantially increase exports of clothing to the US have been eligible for the liberal rule of origin and to source fabrics globally. Preferences for clothing products subject to the liberal rule of origin have been fully utilised. Mauritius and South Africa are the only two countries that are eligible for clothing preferences but which have not been granted liberal rules of origin. In 2002, 90 percent of exports from Mauritius to the U.S. were clothing products, yet only 41 percent of the available preferences for these products were taken up. Clothing only accounts for about 4 percent of South African exports to the U.S. although the absolute amount is similar to that exported by Mauritius. In 2002 only 47 percent of the available preferences for South African clothing products were actually utilized. The issue with the more restrictive rules

⁵ Here it is interesting to look at Lesotho, which in 2002 exported \$321 million of goods to the US (entirely clothing, duty free under the liberal rule of origin) whilst exports to the EU were only 14 million euro. Lesotho has duty free access to the EU for clothing but there are the much more restrictive rules of origin.

of origin is not just the constraints that these rules impose on the sourcing of inputs, forcing producers to use higher cost fabrics and materials, but also the costs and difficulties in proving conformity with these rules compared to the more liberal rules where fabrics can be globally sourced.

The EU has initiated a fundamental review of its preferential rules of origin. The Green Paper issued by the Commission⁶ to promote discussion of reform accepts that “the Community’s efforts to attain its development objectives are sometimes hampered by the fact that the developing countries that are potential beneficiaries of the preferences are unable to take full advantage of them for a series of reasons, among them the difficulty of complying with some of the rules of origin.” The Commission further accepts that the beneficiaries “often lack the production facilities, investment opportunities or administrative organization needed to meet the conditions imposed.... the complexity of some of the rules, the fact that some traders have difficulty understanding them and the cost of the relevant formalities.”

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

2.4 Rules of Origin, Customs and Trade Facilitation

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

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

⁶ http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0787en01.pdf

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

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

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

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

- *Rules of origin entail additional burdens on customs.* Three quarters of those Customs officials who responded believe that clearance of preferential imports requires more manpower to deal with issues arising from the preferential rules of origin. One element of this is likely to be that in most trade agreements proof of origin is required for every single shipment. In general, the additional burden on Customs from preferential rules of origin will be greater the more complicated the rules of origin and the more manpower resources that are required to check conformity with those rules of origin.
- *Overlapping rules of origin from multiple FTAs cause problems.* Almost half of the respondents responded that in their experience overlapping rules of origin were a problem. Of respondents in Africa, two-thirds agreed that problems arose from the presence of overlapping rules of origin. This suggests that there would be gains from some coordination of rules of origin across regional trade agreements with common members. Further, it suggests that a movement towards simple and clear rules of origin in preferential trade agreements would help to minimize the problems caused by overlapping rules of origin.
- *The value-added criterion is particularly difficult to implement.* More than 75 percent of the respondents reported that, of the different methods of conferring origin, the value-added criterion was particularly difficult to implement. This is a striking result but one that is understandable given the heavy demands on data and calculations made by value-added rules. Value-added rules lack predictability since changes in factors exogenous to the firm, such as exchange rates, can lead to different determinations of origin. operations that confer origin in one location may not do so in another because of differences in wage costs. An operation that confers origin today may not do so tomorrow if exchange rates change. Box 3 discusses one way in which the implementation of a value-added rule can be improved by allowing computation based upon net cost as an alternative to ex-works price. The latter being used in EU agreements and SADC. This all suggests that trade could be facilitated by providing for alternative means of conferring origin, such as through change of tariff classification. In other words companies can satisfy *either* a value-added rule *or* another rule such as change of tariff heading.

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

In general, clear, straightforward, transparent, and predictable rules of origin that require little or no administrative discretion will add less of a burden to Customs than complex rules. In this regard, if the objective is to stimulate trade, the use of general rather

than product specific rules appears to be most appropriate for preferential rules of origin. Less complicated rules of origin encourage trade between regional partners by reducing the transactions costs of undertaking such trade relative to more complex and restrictive rules of origin.

Box 3: Improving Implementation of the Value-Added Rule

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

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

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

Example: Comparison of EU and US Approaches to Value-Added Rules of Origin: Light bulbs

US:

Basis of calculation: Net cost (cost of manufacture)

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

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

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

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

EU:

Basis of calculation: Ex-works price

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

Ex-works price = sales price – cost of shipping

Example: Cost of imported ballast \$0.69 per bulb

Case 1: Product shipped to market with good transport links

Box 3 cont'd:

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

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

Case 2: Product shipped to market with bad transport links

Shipping cost = \$0.4

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

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

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

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

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

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

Source: Example based on Barsony 2004

Overall, the analysis of preferential trade agreements in recent years has led to the following broad conclusion

Restrictive rules of origin constrain international specialization and discriminate against small low-income countries where the possibilities for local sourcing are limited. Simple, consistent and predictable rules of origin are more likely to foster the growth of trade and development. Rules of origin that vary across products and agreements add considerably to the complexity and costs of participating in and administering trade agreements. The burden of such costs fall particularly heavily upon small and medium sized firms and upon firms in low-income countries. Complex systems of rules of origin add to the burdens of Customs and may compromise progress on trade facilitation.

and these basic recommendations

1. Specifying generally applicable rules of origin, with a limited number of clearly defined and justified exceptions, is appropriate if the objective is to stimulate integration and minimize the burdens on firms and Customs in complying with and administering the rules. Unnecessary use of a detailed product-by-product approach to rules of origin is likely to lead to complex and restrictive rules of origin and to constrain integration.
2. Producers should be provided with flexibility in meeting origin rules, for example, by specifying that *either* a change of tariff requirement *or* a value-added rule can be satisfied.
3. Restrictive rules of origin should not be used as tools for achieving economic development objectives, as they are likely to be counterproductive. The potential benefits of trade agreements amongst developing countries can be substantially undermined if those agreements contain restrictive rules of origin.

It is in this light that we now proceed to review the rules of origin that were adopted for the SADC trade protocol and assess whether they are likely to be commensurate with the objective of stimulating both regional trade and integration into the global economy.

3. The Evolution of SADC Rules of Origin

3.1 The Initial Rules of Origin Proposed for SADC

By international standards the SADC rules of origin are relatively complex and restrictive.⁷ They did not start out that way. In the initially agreed Trade Protocol the rules were simple and non-restrictive, commensurate with the first recommendation above, and consistent with those in other developing country PTAs, including most importantly COMESA. The geographical proximity and overlapping membership of SADC and COMESA made it seem very sensible to harmonize their rules of origin. This would minimize compliance and enforcement costs, reduce confusion, and avoid costly diversion of activities between COMESA and SADC to take advantage of differences in the rules. Most importantly, as will be argued further below, the COMESA rules turn out to be an

⁷ See Estevadeordal and Suominen (2004).

excellent model, especially for developing economies, in light of both their economic effects and administrative simplicity and transparency.⁸

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

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

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

3.2 Concerns about the Initial Rules of Origin

The original agreement began to unravel and an entirely new direction taken when negotiators started to consider the need for exceptions for particular sectors. Lying behind the discussions of individual sectors were four main concerns, some were explicit and others implicit during the negotiation processes.

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

Two things would be necessary for this to happen.

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

As discussed earlier in Box 2 introducing restrictive rules of origin is not an appropriate response. Detailed and product specific rules of origin tend to

⁸ One problem, however, with the COMESA rules of origin is that imported inputs must be valued on a c.i.f basis in regional content calculations, which effectively discriminates against land-locked countries. SADC has adopted a superior approach of valuing imported inputs at their point of entry into the SADC region so that the additional transport costs for land-locked countries are not included.

complicate customs procedures and drain scarce manpower from other activities. There is no reason why weak customs administrations will be better able to apply restrictive rules of origin than more liberal rules and there is nothing that necessarily makes it more difficult to fraudulently forge a certificate of origin for a set of restrictive rules of origin than for a less restrictive set of rules. Weak customs administration is a fact of life in almost all developing countries and contributes to many development problems. Recognizing this, as well as the fact that it might undermine the Trade Protocol itself, improvement of customs procedures and administration is an important part of the SADC policy agenda.

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

In fact the use of rules of origin in such a manner is more likely to have adverse development consequences. When inputs are efficiently produced within the region there is no need for rules of origin to encourage their use by downstream producers – such products will be demanded anyway. Hence, using rules of origin to encourage use of regional inputs will force producers to use higher cost inputs than they would otherwise have chosen and will make it less easy for such firms to compete in both regional and global markets with suppliers from other regions who are able to source their inputs from the cheapest sources.

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

However, such a rule of origin raises the costs of all producers wanting to compete in regional markets, tends to favor the producers of downstream goods in countries that have local supplies of the relevant inputs, prevents or at least strongly discourages preferential trade among Member States that do not have local suppliers of the inputs, and penalizes SADC consumers that might otherwise gain

from greater freedom of regional trade. These are the kinds of side effects and questions that need to be considered in using rules of origin to compensate for cost-raising protection of input producers in certain Member States. Another question is the extent to which protection of local input producers actually raised costs and benefited these producers, especially in the agricultural sector.

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

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

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

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

3.3 The Current Rules of Origin Regime

Eventual agreement was reached on rules for almost all sectors and products. However, the regime in the amended Trade Protocol is very different than had been agreed

originally. It is characterized by ‘made-to-measure’ sector-specific rules that vary widely across chapters, headings and subheadings, and in general are significantly more restrictive. The change of tariff heading requirement has been replaced in many cases by multiple transformation rules and/or detailed descriptions of required production processes. Value added requirements have been raised and often considerably, and permissible levels of import content have been similarly decreased.⁹

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

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

3.4 Current SADC Rules of Origin: Sectoral Issues

3.4.1 Agriculture and Processed Agricultural Products

There has been strong pressure to use rules of origin to encourage the use of local agricultural raw materials in downstream processing industries so as to encourage development of local agriculture and to stimulate greater regional value added in agriculture through further downstream processing rather than the export of unprocessed raw materials.

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

⁹ 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.

products as a result of SADC trade liberalization. The issues are best illustrated by examining a few particular cases.

*Wheat Flour*¹⁰

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

These proposals are best understood against a background of large variations in production capacities and in the regulatory environments for these products in SADC Member States. Several members produce significant amounts of wheat, although none are 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. SADC as a whole is not self-sufficient in wheat. Some Member States provide considerable protection to local wheat growers and others provide none. Similarly, there are large variations in the amount of protection given to downstream producers of flour and its products. In addition, there has been significant and rapid deregulation in these industries in some member states recently, especially South Africa.

What would be the implications of applying the more restrictive rules of origin for flour that have been proposed? In answering this question it is important to consider not only the producers of wheat and flour in SADC members but also consumers of these products and 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.

Significant differences in external protection of wheat have underpinned the difficulties in agreeing on suitable rules of origin for wheat flour. Tanzania and South Africa/SACU 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.¹¹ This wheat

¹⁰ The argument in this and the following section is developed in more detail in Erasmus and Flatters 2003.

¹¹ 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.

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

However, given that SADC as a whole and all individual members are net importers of wheat, a rule of origin requiring significant amounts of regionally sourced wheat could not 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 outside of SACU. In practice it has become apparent that the SACU wheat tariff does little to protect domestic wheat growers in South Africa and to do little harm to flour millers and so this argument for restrictive rules of origin appears to be largely redundant.¹² Further, with a few exceptions, notably Malawi and Mauritius, where effective rates of protection are zero, SADC milling industries enjoy considerable protection. Restrictive rules of origin would ensure that SADC does not undermine the positions of oligopolistic firms that face little threat from external competition.

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

Products of Wheat Flour

Unlike flour, products such as pasta and biscuits (chapter 19) are 'two steps removed' in the production chain from the original agricultural raw material – they are products of processed agricultural goods rather than of the raw materials themselves. Nevertheless, restrictive rules of origin based on requirements to use flour milled from locally produced wheat were seriously proposed. Once again it was argued that this would promote demand for local agricultural products, in raw and processed form.

Good quality European style pasta requires durum wheat, which is not produced in the climatic and soil conditions prevalent in SADC. Local wheat can be used and some of the deficiencies can be overcome through use of special additives and heat treatment. While this makes it technically possible to produce 'European' type pasta, it is of higher cost and lower quality. The resulting pasta is brittle, and tends to crumble in shipping and storage, before the consumer ever opens the package.¹³ Most local pasta producers use

¹² See Box 2 of Erasmus and Flatters 2003.

¹³ A recently completed pasta plant in Namibia employs a high temperature process that overcomes some of the technical problems related to brittleness of product using local wheat. Nevertheless many consumers there and elsewhere find the flavor and other properties unacceptable and are willing to pay much higher prices to obtain better tasting pasta made from durum flour.

flour milled from imported wheat, regardless of import duties.¹⁴ Similarly, the production of quality biscuits requires the use of flour from wheat grown outside of Southern Africa.

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

Further, restrictive rules of origin would hamper the ability of local producers to develop production capacities to exploit available market opportunities in broader export markets outside of Southern Africa in these sectors. Requirements to use inputs from different sources for products destined for regional markets compared to products for international markets undermines economies of scale and effective sourcing, sales and marketing strategies.

Requiring only that the flour be milled in the region, but not necessarily from regionally grown wheat (the equivalent of a two stage transformation requirement), would be much less restrictive. However, it would still deprive producers of downstream products of the flexibility of using imported flours. To import grains in small quantities and have them milled in the region would often be much more costly than simply importing the required flour products, especially for specialty products not required in large quantities.

A simple change of tariff heading rule is all that is necessary for these products. Indeed, this has been recognized for the specific case of pasta made from durum wheat flour. But the logic which led to this decision has not yet been carried over to other products of wheat flour. No rules of origin have been agreed making it impossible for preferential trade between SADC members. Thus, the protocol is doing nothing to promote larger investments in these sectors or the development of internationally competitive producers.

Coffee, Tea and Spices

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

- increasing demand for a regional agricultural products and so the incomes of producers and/or

¹⁴ In the case of South African pasta exports, the effect of import duties on flour is largely offset by use of the government's duty rebate facility for exporters.

- encouraging downstream processing.

The original chapter rule for these products 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 be wholly originating in the region, and
- for curry and mixtures of spices, there must be a change of tariff heading and all cloves used in such mixtures must be wholly originating in the region.

However, in practice, given the nature of these processed products, these rules will not accomplish any of their intended goals, for primary producers or for processors, and they will have the unintended consequence of preventing any intra-SADC preferential trade. They will 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 3 for the case of instant coffee. Sourcing of raw materials for blending of coffee, tea and spices is a complex process. Relative to the variety of raw materials available in the world, SADC Member States produce only a very narrow range. Hence, SADC producers, as elsewhere in the world, have to source raw materials from all around the world. Skillful sourcing and selection of raw materials in the global market is a key to international competitiveness. Therefore, restrictive rules of origin simply hinder the development of downstream processing industries.

Box 4: The Importance of International Sourcing: Instant Coffee

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. 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.

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 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 is of no benefit to local growers.

In fact, restrictive rules of origin will exclude from SADC preferences most of the products currently produced in the region. 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 will be deprived of preferential access to SADC markets under current rules. As with wheat and wheat flour, the ultimate cost of restrictive rules of origin on these products will be borne by regional consumers and by producers seeking to expand on the basis of global market strategies. Elimination of regional content requirements for the items in HS chapter 9 would provide further opportunities to improve the international competitiveness of SADC producers of these products, increase regional competition for the benefit of consumers and would do no harm regional growers of the raw materials.

3.4.2 Selected Industrial and Manufactured Products

Light Manufacturing

Some of the most contentious issues on manufacturing rules of origin rules have arisen in the light manufacturing industries in HS chapters 84, 85 and 90. These include mechanical and electric 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 or net cost. In other words, a minimum local/regional content of 35 percent of *ex*-factory cost was required. It was then proposed that the basis for value calculations be changed from *ex*-factory cost to *ex*-works price, the method used in EU rules of origin. In general a given content requirement will be more restrictive when expressed in relation to the *ex*-works price compared to the net or *ex*-factory cost. According to calculations presented by SACU, using the *ex*-works price as the basis for valuation would be equivalent to requiring that domestic content amount to 45 percent of the net cost or lowering permitted non-originating content from 65 to 55 percent on the net cost basis. A compromise eventually was reached on a chapter rule for chapters 84, 85 and 90 requiring a maximum import content of 60 percent of the *ex*-works price.

Box 3 highlighted some of the difficulties that arise in using the *ex*-works price as a basis for valuation. Any value measure is subject to some uncertainties when market prices of inputs and outputs vary over time. Such uncertainties are multiplied when the prices are determined in international markets and quoted in multiple currencies. In SADC, where the importance of several resource-based economies makes exchange rates quite volatile, these uncertainties can be a major problem. The same economic activity might satisfy the rules

of origin at one set of exchange rates and not come close to satisfying them under the exchange rates prevailing some later time. This can be especially true when, as in SADC, goods might be sold in several different markets, and changing exchange rates can have a significant impact on prices when measured in any particular currency. Measuring values at *ex-factory* costs can help to reduce one major source of exchange rate uncertainty, giving greater comfort to both buyers and sellers in predicting whether sales and purchases will satisfy the rules of origin. One option to consider in SADC would be to follow the approach in NAFTA and specify *both* a requirement in terms of the maximum import content of the *ex-works* price and a slightly lower maximum import content of net or *ex-factory* cost and allow for *either* to be satisfied.

Regardless of the basis for determining values, however, the most important issues relate to exceptions to the chapter rule. Several Member States, most importantly South Africa, identified certain chapter sub-headings in which they had a special interest, by and large products in which they had existing (or potential) producers selling behind high import tariff barriers. For all such products, South Africa proposed rules of origin that were more restrictive than the general chapter rule. After negotiations that went on until late 2002 it was finally agreed that eight four-digit HS chapter sub-headings would ‘benefit from’ a more restrictive 45 percent maximum import content requirement. A further 14 4-digit headings in chapters 85 and 90 have a 55 per cent maximum import content in relation to the *ex-works* price. However, agreement was made subject to reconsideration during the mid term review of the Trade Protocol.

Several justifications were provided for the stricter rules. Most were based simply on the desire to protect existing industries against the possibility of increased competition arising from freer trade in the region. This clearly violates the intention of using the Trade Protocol to promote trade and integration in SADC.¹⁵ A variation on the protection argument is the fear that, without restrictive rules of origin, trade liberalization would lead to a flood of imports from new ‘screwdriver’ industries set up in neighboring countries to take advantage of the Trade Protocol. This argument ignores 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 were also used to justify a more restrictive rule. These are all issues for which rules of origin are not the appropriate tool. To try to use rules of origin for such objectives would reduce their effectiveness in achieving their legitimate goal of preventing trade deflection in preferential trade agreements, and would fail to achieve the social and economic goals for which they had been mistakenly chosen.¹⁶

¹⁵ In addition, it became clear that such demands could be based on inadequate and incorrect information concerning local industry. 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.

¹⁶ See Box 2 of Flatters 2002b for a discussion of these dumping and safety issues with respect to the case of electric cable.

While the ‘protectionist argument’ for restrictive rules of origin had some superficial plausibility and gained some acceptance, especially in the early stages of the negotiations, subsequent analysis and information gathered through examination of the firms and sectors for which they were intended yielded a very different picture. The improvements in understanding related to both the likely economic impacts of restrictive rules and the economic circumstances and interests of the sectors for which they were proposed. It was the closer investigation of the circumstances and interests of the affected sectors, especially in South Africa, that produced the most interesting and (initially) surprising results.

High levels of trade protection – high tariffs on final goods, lower tariffs on imported components or kits, and sometimes additional incentives to source some inputs locally – have encouraged the development of some high cost activities that are unable to compete internationally in terms of price or product quality. The small scale of production necessary to meet local market demand makes it difficult to achieve internationally competitive cost levels. These activities nevertheless remain a source of a certain amount of income and employment, supported at the expense of consumers and/or industrial users of the protected goods. International evidence, as well many examples in SADC, show that local assembly activities focused on supplying protected domestic markets are unsustainable and often account for negligible amounts of economic activity, technology transfer or employment. Box 5 provides one such example, interestingly of a sector where the more restrictive value-added requirement has been adopted in SADC. Hence, designing rules of origin around such protected producers is misguided.

Box 5: Rules of Origin, Regional Trade Liberalization and Jobs

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

Following the introduction of free trade under COMESA, the refrigerator industry came under pressure from competing Egyptian products. What was the response of the Government of Mauritius? The Government felt it was inappropriate for Egyptian producers to have special access to the local market simply by virtue of Egypt’s membership in COMESA. The reaction, however, was *not* to erect new barriers to these imports as they may have been urged by local producers. Instead, it was decided that local consumers should be able to benefit from competition by *all* local and international producers of refrigerators.

To accomplish this, the MFN import duty on built up refrigerators was reduced to 20 percent, the same as the rate on CKDs and parts. This gave local assemblers a reasonable rate of effective protection of 20 percent and allowed consumers the benefit of equal access to all international suppliers of refrigerators. The 20 percent import duty together with the relatively new VAT provided substantial increases in government revenues. The only possible losers were those engaged in local refrigerator assembly. The main assembly operation did indeed shut down; its scale was far too small to be competitive. The company now concentrates on imports, distribution and sales of these products in Mauritius, in line with its main economic activity, with an insignificant change in its net income. What about employment? The 15 to 20 persons who had been

engaged in refrigerator assembly had to be redeployed elsewhere in the company – a relatively minor adjustment.

The COMESA rule of origin for refrigerators requires 25 percent local/regional content. (The general rule for the manufacturing sector is 35 percent.) A 50 or 60 percent local content rule would have eliminated the import ‘threat’ (or opportunity) that triggered these changes in Mauritius.

Source: Case study interviews. See Flatters 2002b.

At the same time, there are also significant and growing numbers of internationally competitive exporters in these sectors. There are examples of intra-industry trade within the region as well as exports in a variety of niche markets to various other parts of the world, including Europe and North America. Extra-regional exports account for a growing share of production in these sectors, and also generate considerable employment. Many of these are ‘new exports’ that have become more competitive due to MFN-based trade liberalization in the region over the past decade. What were once inward-looking import substitution industries have become more active players in global markets. This has generated many new regional jobs which are likely to be more sustainable than those in highly protected uncompetitive firms. Box 6 provides an example of the sourcing practices in a sector, small electrical appliances, which has seen competitive exporters emerge following liberalization of the South African economy over the past decade and highlights the importance of non-restrictive rules of origin to stimulate regional trade and allow firms to adopt for broadly based, global trade strategies.

Box 6: 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 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.

It is important to recognise that to be able to compete, locally, regionally or internationally, producers often prefer to be able to source raw materials and inputs locally. But to remain competitive, they also must have the flexibility to obtain such materials from

the best sources anywhere.¹⁷ In other words, when high levels of local content are motivated by cost considerations and by efficient production rather than by responses to government edicts or incentives, existing producers have nothing to fear from competitors that might set up operations with lower levels of local content in the same country or in other SADC Member States.

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. It seems evident as well that a 35 or 45 percent local content threshold, together with the general disqualification of pure assembly industries will more than suffice to prevent unfair competition from screwdriver assembly activities. More restrictive exceptions to such a general rule are at best unnecessary, and at worst will serve as a barrier to intra-SADC competition and to the expansion of firms that wish to become fully engaged and competitive in the international economy. Thus, in the globalised economy of today, rules of origin are best set in a policy framework that encourages and facilitates flexible sourcing of raw materials and intermediate products to foster efficient and competitive manufacturing activities. In such a way SADC could not only promote greater trade in the region but also help the region to become a platform to increase its competitiveness in world markets.

These considerations have been recognized by many decision-makers and stakeholders. Earlier this year, for instance, Namibia and Mauritius submitted a list of products at the 6-digit level in HS chapter 85 in which they claimed to have an interest, in the sense that there is thought to be the possibility of development of local production of these products. In order to facilitate such development of these sub-sectors a request was made for *less* restrictive rules of origin. This shows full recognition of the need for flexibility in the sourcing of raw materials and inputs, especially in the early stages of economic development. Restrictive rules would reduce this flexibility.

Textiles and Garments

¹⁸

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 labour intensity and other determinants of comparative costs at

¹⁷ 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.

¹⁸ This section draws on Flatters 2002a.

various stages in the textile and garment 'value chain' also mean that there are potentially significant complementarities among member states which, through SADC trade initiatives, might enhance the region's competitiveness in world markets. It is a sector in which some member states, most importantly Mauritius, have already demonstrated the potential of the region. The opportunities recently opened up through the Africa Growth and Opportunities Act (AGOA) together with the looming uncertainties arising from the end of the Agreement on Textiles and Clothing (ATC) make this a crucial time for remedying domestic and regional policy weaknesses that have hindered the region's international competitiveness.

The 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).¹⁹ With a few exceptions, including yarn, the rules of origin require a double transformation in order to qualify for SADC tariff preferences – garments must be made from regionally produced textiles; fabric must be made from regionally produced yarns; yarn must be made from uncarded, uncombed fibre or from chemical products. The double transformation rules for garments and fabric are waived for the four poorest member states, Malawi, Mozambique, Tanzania and Zambia (known as the MMTZ countries), but only until 2005, 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.

Many member states apply relatively high MFN tariffs to goods in these sectors, and so tariff-free access to SADC markets would provide a high degree of preference relative to external markets. However, the rules of origin will be very difficult to satisfy for most regional garment producers. The rules of origin and tariff liberalization schedules in SADC were shaped primarily by the existing policy regimes and by certain of the key interests in the domestic textile and garment industries in the Member States. The rules of origin rely heavily on the model of the EU-South Africa free trade agreement.

With a few notable exceptions the SADC region's textile and garment industries have tended traditionally to be inward oriented and uncompetitive in international markets. MFN tariff rates are high, and most sales of domestic producers are in domestic and regional markets. It is the interests of the groups focussed on domestic markets that were best represented in the negotiations on rules of origin. Even within the most heavily protected markets, however, the ongoing process of trade liberalization and the opening of new external opportunities, and in some cases the provision of special export incentives have generated internationally competitive activities at all stages in the textile and garment value chain.²⁰ Box 7 briefly describes the situation in the key players in this sector – South

¹⁹ 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.

²⁰ Export 'competitiveness' of some firms in South Africa has been assisted in small part as well by special export incentives, most notably a 'duty credit certificate' (DCC) program which rewards exporters with special import privileges into the heavily protected domestic market.

Africa and Mauritius, highlighting their different circumstances – the former largely inward looking and the latter much more export oriented – which have resulted in quite different interests in and approaches to SADC. Some observations are offered as well on Lesotho and Namibia, both export oriented and until recently much smaller players in the regional textile industry.

Box 7: Textiles and Garments in Three SADC Member States

South Africa

South Africa's textile and garment sector is heavily protected and/or regulated at all stages in the value chain. The tariff structure is high and escalating, with tariff rates of 10 to 18 percent for yarn, 20 to 22 percent for fabric, 34 percent for blankets, linens and curtains, and 40 percent for garments. Cotton fibre imports are duty free but are subject to domestic purchase requirements – all domestic fibre must be purchased before imports are permitted. This structure of protection has created a domestic industry that is focused primarily on the domestic market. While the import duty on garments is 'only' 40 percent, the escalation of the tariff rate structure provides effective protection to garment making in the neighbourhood of 60 to 70 percent for domestic sales. This is despite the cost-raising impact of relatively high import duties on fabric. At the same time, special export incentive programs, have created a number of niche market exporters, in capital-intensive upstream sectors as well as labour-intensive garments. At whatever stage they are located in the textile and garment value chain, most exporters rely primarily on imported raw material inputs.²¹

In the upstream fibre, spinning and weaving industries only a small proportion of sales appear to be in the form of 'indirect exports' through garment producers. Most spinning and weaving firms produce a variety of products, few of which are used in the garment industry. Products include shoe cloth, bedding and furniture upholstery fabric, and industrial cloth for many uses including tire cord, car seats, car tops, seat belts, luggage, road fabric and mining curtains. For firms that do export, the most important exports are industrial textile products that are assisted considerably by the export incentive and subsidy programs. Garment producers that do export source inputs internationally. The result is a dual market – activities focused on exports and those aimed at the high cost and heavily protected domestic market. The latter is still the dominant part of the South African industry.

Mauritius

The textile and garment industry in Mauritius is predominantly export-oriented. A policy environment which has facilitated easy and low cost access to world markets for inputs and outputs has permitted Mauritian-based textile and garment producers to become internationally competitive. Access to duty free imports and other export processing zone (EPZ) privileges made a significant contribution to the growth of the Mauritian textile sector.

Although some domestic interests initially and inexplicably supported restrictive rules of origin and a slow phase-in of SADC free trade in this sector, it is now almost universally recognized in Mauritius that a speedy phase-in of tariff reductions and unrestrictive rules of origin are in the best interest of future development in Mauritius. Most representatives of the textile and garment sector would now advocate immediate SADC-wide free trade and a single transformation rule of origin as the best way for Mauritius and the rest of SADC to take advantage of the unique and time-limited opportunities provided by AGOA.

²¹ See the earlier discussion concerning the low rate of utilization of AGOA preferences by South African exporters, presumably due to the use of imported fabrics and so the inability to satisfy the restrictive triple transformation (manufacture from fibre) AGOA rule of origin.

Lesotho

Lesotho, a small least developed and landlocked country, has experienced export led economic growth in recent years fuelled by FDI into export-oriented manufacturing, largely in the garment and textile sectors. This FDI has in turn been influenced by the treatment of products from Lesotho in the major markets, and especially duty-free access with liberal rules of origin under AGOA and the indirect preferences arising from the quotas applied to major developing country producers, such as China, under the Agreement on Textiles and Clothing.

Most of the inputs used by foreign-owned firms established in Lesotho come from east Asia, the cheapest and most efficient source. The single transformation rule of origin under AGOA has permitted clothing produced with such inputs to be exported duty free to the US market. Due to the growing scale of garment production, however, there have been some recent investments in upstream textile production. Production of garments for export to the US increased almost three-fold between 2000 and 2003. More than 30000 jobs have been created, with the primary beneficiaries being the urban poor and women. As noted earlier, Lesotho has not been able to expand exports to the EU where a double transformation rules of origin severely constrains the impact of trade preferences.

Namibia

Namibia is a very small country, at least in terms of market size for garments and textile products. Under SACU, of course, it is part of the greater South African market and benefits (and suffers) from many of the features of the South African trade and industrial policy regime. Historically, it has not been a participant in the regional or global garment and textile industries. As recently as mid-2001, studies of regional development possibilities in this sector did not give any serious attention to future possibilities in Namibia.

While there continues to be talk about the need to develop import substitution industries in Namibia, garments and textiles have not been part of any such schemes. Furthermore, there is growing recognition that any significant investment and employment possibilities in the manufacturing sector must ultimately be export-oriented. It is in this context that Namibia was well prepared to take advantage of the opportunity to host the huge AGOA-oriented investment being planned by the Malaysian company, Ramatex Bhd. With no vested interests in preserving access to a protected domestic market, the government encountered no extraneous constraints in negotiating arrangements with this large investor.

Source: Flatters 2002a

One justification for the double transformation rule was that it would encourage regional sourcing and deeper integration of the regional textile and garment industries. An examination of the regional industry, however, reveals very little such integration at the moment, especially for import substitution oriented producers. The scale of the local and regional markets alone is simply too small to make such integration economic. Even in South Africa, the largest and most sophisticated market, the vast majority of garment producers use imported fabric and cannot compete in international or even highly protected local markets if forced to use regional inputs.²² In the extreme, manufacturers of brand name apparel using, for example, high quality Italian cotton fabric, cannot source from a South African producer at any cost.²³ 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.

Such a restrictive rule was supported by reference to its use by the EU and the US in its recent bilateral trade agreements. But here it has to be recognised that the main motive for a such a rule in the EU and the US is to ensure that their trade agreements do

²² Source: case study interviews.

²³ See Box 3 of Flatters 2002a.

not result in increased competition from lower cost garment and textile producers. In the SADC case this motivation to constrain intra-regional trade was further underpinned by the argument that high duties on imported inputs, such as yarn or fabrics, in certain countries would undermine the ability of garment producers in those countries to compete under regional free trade with producers in other lower duty countries in SDAC. A double transformation rule ensures that producers using imported inputs cannot compete on a regional basis in SADC. Thus, such a rule will constrain intra-SADC trade in this sector and, in addition, will do nothing to promote the global competitiveness SADC textile and garment producers.

Important changes have occurred since the rules of origin for textiles and clothing were negotiated. The rules were agreed prior to and without reference to AGOA. They were considered without reference to the expiry of the Agreement on Textiles and Clothing (ATC) which will occur in 2005 and which may have a profound impact on the competitiveness and market access of SADC producers in global markets. It is also important to reflect that the EU is currently reconsidering its rules of origin for its preferences towards developing countries. To take advantage of international export opportunities and to adjust to an increasingly competitive global textile and clothing sector after 2004, producers at any place in the garment and textile value chain need as much flexibility as possible in sourcing raw materials and intermediate inputs. Constraints that have any effect on these choices increase costs and hence reduce international competitiveness in one of the most demanding and competitive sectors of global trade.

The Motor Industry

The SADC motor industry, both vehicles and components, is dominated in terms of market size, volume, value and diversity of production by South Africa. Several other SADC countries have small assembly and after-market components industries. There are a small number of OEM (automotive original equipment maker) components makers outside of South Africa, but mainly in SACU. In all countries, including South Africa, the largest share of employment is in distribution, sales and after market service. South Africa's industry has been driven in recent years by the Motor Industry Development Program (MIDP), which provides substantial subsidies to investment and production of vehicles and OEM components for export.

The rules of origin for this sector under the SADC trade protocol specify a general chapter rule of a maximum import content of 60 per cent of the ex-works price. However, there are a large number of exceptions. For vehicles, the maximum import content ranges from 55 to 60 per cent, and for most components it is less, generally 50 per cent. For vehicles, there are also additional requirements stipulating that various assembly operations must be undertaken, such as, the fitting of the engine, transmission and electrical equipment to the chassis. These rules were drawn up on the basis of preventing the emergence of simple screwdriver operations. However, in practice most of these rules cannot be satisfied even by producers in South Africa.

The small scale of production in most SADC markets makes it impossible for producers to be able to compete in terms of cost or quality globally or relative to producers

in South Africa. The restrictive rule of origin is redundant. Even in South Africa, most, if not all, producers would have great difficulty satisfying the agreed rule of origin and so are unable to exploit the opportunities for preferential export within the SADC region. South African producers are exporting to world markets. They have little to fear from competition by small-scale producers in other SADC Member States, they could even benefit from outsourcing certain labour activities to lower cost neighbours.

4. The SADC Trade Protocol and Trade Flows

There is very limited data available on intra-SADC trade and more precisely on the amount of trade which is being granted preferences under SADC. Here we exploit data provided to us by the South African Revenue Service on the amount of imports entering South Africa which is classified as taking place under SADC. Table 1 summarises the data on imports from 6 non-SACU members of SADC. It is very important to treat the following analysis with a high degree of circumspection since, as far as we are aware, this is the first time that these data have been assessed and difficulties have been encountered in matching the trade data with the available tariff schedule. There are also a number of anomalies, such as imports registered as entering under SADC even when there is no SADC preference and potential product misclassifications, that have not been resolved. Nevertheless, we do believe there is some value in the information, which is highly relevant to discussions concerning the impact of SADC and so with the above strong caveats in mind we proceed to discuss the key conclusions we take from a simple analysis of the data.

Table 1 shows that whilst the value of exports to South Africa from these six SADC countries has almost doubled over the past 4 years *exports recorded under SADC have grown slower than total exports to South Africa*. For this group of countries as a whole the share of exports under SADC as a proportion of total exports to South Africa has fallen from 41 per cent in 2000 to 29 per cent in 2003. This reflects that exports of products subject to zero MFN duties have grown faster than exports subject to preferences under SADC.

Table 1: An Initial Analysis of Trade under SADC: Exports to South Africa, 2000-2003

	Mauritius	Malawi	Mozambique	Tanzania	Zambia	Zimbabwe	Total
Total Exports (Rand Mill)							
2000	45.57	181.13	309.51	24.14	290.52	1,279.37	2,130.25
2001	156.42	324.83	301.33	37.74	417.86	1,430.73	2,668.91
2002	92.68	479.87	401.06	94.67	771.01	2,122.21	3,961.50
2003	122.9	377.9	278.56	134.21	564.9	2,602.18	4,080.65
MFN Duty-Free Exports (% of Total Exports)							
2000	57.90%	9.40%	61.60%	53.40%	51.70%	35.10%	39.70%

2001	72.60%	13.00%	60.40%	51.00%	49.60%	27.90%	36.10%
2002	51.40%	8.60%	64.10%	25.30%	36.30%	48.80%	42.50%
2003	52.10%	14.50%	42.20%	56.70%	36.20%	59.90%	50.90%
Exports under SADC (% of Total Exports)							
2000	36.60%	87.10%	4.90%	36.90%	18.00%	49.00%	41.20%
2001	19.80%	70.30%	12.20%	43.70%	11.30%	45.90%	38.10%
2002	40.20%	33.50%	22.90%	30.40%	9.70%	37.00%	29.70%
2003	38.00%	37.70%	30.10%	41.30%	17.80%	28.50%	28.70%

This shows that these countries have been able to increase exports to South Africa of products where there are no preferences and suggests an ability to effectively compete in these products with other suppliers of the South African market. Hence, the main factor driving the increase in the share of these countries in South African imports (from 1.24 per cent in 2000 to 1.74 per cent in 2003) has been non-preferential products.

The overall conclusion is driven mainly by the performance of Zimbabwe, the picture amongst other countries is more mixed. Exports by Zimbabwe to South Africa dominate the exports of these 6 countries, accounting for more than half of the exports of this group. For Mauritius and Tanzania, exports under SADC have grown slightly faster than total exports to South Africa, for Zambia exports under SADC have remained a constant share of total exports (although the fastest growth has occurred for products subject to duties but which receive no SADC preference), for Malawi, exports under SADC have declined absolutely despite a doubling of exports to South Africa. Finally, exports by Mozambique under SADC have increased substantially in a declining total.

This very tentative analysis suggests a mixed picture across countries and that whilst there has been a substantial increase in overall exports to South Africa from these 6 countries, the direct impact of the SADC trade protocol has been rather muted. Non-preferential trade has grown at a faster rate than preferential trade. This may reflect the lack of comparative advantages in the products to which South Africa continues to provide external protection. It may reflect the slow reduction of tariffs under SADC for certain key products. It may also reflect the impact of restrictive rules of origin. The arguments in this paper suggest a strong possibility that the latter has been an important factor constraining the trade impact of the SADC trade protocol.

5. Conclusions

Evidence and experience from the SADC region and elsewhere now show that the costs of adopting restrictive product specific rules of origin are high and that such rules are not conducive to long term development. SADC countries themselves are currently highlighting difficulties with similar rules of origin in the Cotonou Agreement with the aim of revisiting them in their negotiations of Economic Partnership Agreements (EPAs) with the EU. Indeed, the EU has accepted that its current rules of origin have constrained its ability to meet its development objectives through preferential trade agreements.

The current SADC rules of origin are likely to limit the ability of the Trade Protocol to promote the development of the region. Restrictive rules of origin are likely to impinge most heavily on the lowest income countries. Rather than facilitating development through trade, the Trade Protocol will replace transparent and declining tariff barriers with complex and more restrictive input sourcing requirements. These will frustrate trade, increase transactions costs, reduce flexibility of producers and make the region a less attractive place to invest than would be the case with an open and flexible region.

Restrictive rules of origin might be in the interests of particular regional producers that wish to avoid new competition in their domestic markets. By the same token, however, such rules will make it impossible for them to compete in other regional markets, make it difficult if not impossible to benefit from attractive sourcing opportunities in the region and elsewhere, and will deprive downstream users, both producers and final consumers of the benefits of preferential tariff reductions. Except for those benefiting from the use of rules of origin to restrict competition, less restrictive rules cannot hurt regional producers. By permitting increased flexibility and reducing transactions costs, they can only help them. These conclusions are supported by case studies of the impacts of SADC rules of origin. Among the more interesting findings was that many firms and sectors which were thought to need restrictive rules actually preferred less restrictive and less costly ones.

Complex rules of origin also complicate the work of customs agents and are likely to increase customs clearance times for both preferential and non-preferential goods. In this way complex rules of origin can compromise key objective regarding trade facilitation. More simple rules of origin backed up by training of customs officials and better information for traders is likely to contribute towards more effective enforcement of rules of origin whilst at the same time facilitating legitimate preferential trade and integration within SADC.

Based on these considerations, the most appropriate rules of origin for SADC would be simple and not restrictive beyond the objective of preventing trade deflection. This could be achieved through general conditions stipulating that simple packaging, assembly and labeling, for instance, are insufficient to confer originating status (current Rule 3 of Annex I to the Protocol), together with rules on sufficient processing that are common across products and give producers flexibility by providing options for compliance. Sensible requirements for goods to be classed as originating in SADC would be that they

- are wholly produced in the region, *or*
 - undergo a single change of tariff heading, *or*
 - contain non-SADC imported materials worth no more than 65 percent of the net cost of the good (or a regional content of 35 percent of net cost) or no more than 60 per cent of the ex-works price of the good (regional content of 40 percent).
- If these suggestions are difficult to implement in the short-run there are substantial improvements that can be made to the existing product specific rules of origin to reduce

the restrictiveness of these rules.²⁴ A review should also be undertaken of the scope for the introduction of exporter self-certification for known reliable exporters which would ease the burden on firms in proving compliance with the requirements of the rules of origin.

A simpler system which is easier to administer and with which it is easier to prove compliance is more likely to stimulate regional integration and facilitate the growth of companies that are able to compete effectively on global markets. This would also bring SADC into line with other agreements amongst developing countries (the ASEAN countries have recently signed an agreement with China, for example, with a requirement of 40 per cent of regional value added common across all products and with the option to satisfy alternative rules for specific products) and the more general trend towards liberalisation of rules of origin in preferential trade agreements.

²⁴ A detailed list of proposed changes is provided in Brenton, Flatters and Kalenga (2004).

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