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

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1. Introduction

There are two quite different and competing visions of SADC. These two visions and the alternate policy directions they imply are well illustrated in the negotiation and evolution of rules of origin under the SADC Trade Protocol.[1]

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

The vision that has driven the development of the SADC Trade Protocol so far has been distinctly inward-looking. Development of policies on rules of origin has responded defensively to fears of external (international and regional) competition and proactively to desires to develop inter-sectoral linkages through administrative requirements. Little attention has been paid to the Trade Protocol as an instrument to capitalize on opportunities for improving international competitiveness and for participating in global markets.

Rules of origin have been among the more contentious issues in SADC Trade Protocol negotiations. Indeed, even three years after implementation of the Protocol, rules have not yet been agreed in several key sectors. A central issue has been the extent to which rules of origin can or should be used to promote economic development in the region. In this sense, rules of origin are similar to local content regulations, a more familiar tool that is a common feature of failed import substitution regimes.

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

2. Background

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

2.1 Trade in Middle Products

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

[1] See Flatters 2001.

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

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

The study of fragmentation of production sheds new light on the link between exports and imports. To participate as a successful exporter in the global manufacturing system a country must be a successful importer; flexibility and low costs in sourcing imported materials are critical ingredients in exporting. Slow and/or costly customs and port procedures raise the cost of importing; administrative requirements on the sourcing of inputs raise costs and reduce flexibility. Such barriers to imports raise the cost of undertaking any stage of the production process in a country that imposes them or permits them to occur. As such, they also reduce investment and exports.

2.2 Lessons from Southeast Asia and Elsewhere

2.2.1 Southeast Asia

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

1. Import-Led Growth in Indonesia: Reform of Import Procedures

In the early 1980s the corruption and inefficiency of the Indonesian ports and customs administration were well known. Cartoons in local newspapers depicted administrative procedures which were designed to maximize the number of approvals (and hence bribes) required to clear imports. Despite their low official salaries, customs officials were known to have large incomes. At the same time, import procedures were notoriously slow, with two to three month clearance times at the port being quite normal. Rather than trying to simplify these procedures, senior customs officials worked with counterparts from other ministries to develop increasingly complex tariff and exemption structures and broaden the scope of non-tariff import restrictions, thus increasing the discretionary authority of Customs and hence their scope for corruption.

The only escape for exporters was an 'export certificates' program that was designed in principle to compensate for duties and taxes paid on imported inputs. In fact this system was based on negotiated 'coefficients' which often were determined more on the basis of political influence than on taxes paid. The system could not compensate for the costs of large delays and uncertainties in import clearing.

In 1984, the government transformed import procedures. Under the new pre-shipment inspection (PSI) system, imports were not inspected on arrival by Customs; they were examined instead in the country of export by an international surveying firm. The PSI report was the basis for the clearance of all import tax obligations, often before the goods arrived. The only role of Customs was to verify that the surveyor's seals had not been tampered with and that there was documentation of payment of taxes. In the absence of clear evidence of tampering, Customs was not permitted to interfere in any way with shipments supported by SGS documents.

The workload of Customs was enormously reduced. However, no officials were fired. They were required to report for work as usual, and were paid their normal government salaries. But, with the opportunities for corruption reduced, their actual incomes fell drastically.

Concurrently with the Customs reform the government also streamlined port procedures and implemented a major deregulation of inter-island shipping rules.

The immediate results of these reforms were spectacular. Within months, members of the Indonesian Importers' Association reported that importing costs had fallen by 20 percent. Clearance times for imports at the ports fell from weeks and months to a few hours. And import tax revenues rose. While this was only the first in a series of trade policy reforms involving special measures for exporters, decreased reliance on non-tariff import barriers, and lowering of import tariffs, it was arguably Indonesia's most important trade liberalization measure of the 1980s.

The pattern was far from static, however. As skill levels changed and wages rose, countries that had specialized primarily in labor intensive production activities moved 'up the ladder' to more skill and capital intensive activities. But regardless of the types of activities that took place in any location, production remained heavily dependent on imports.

Another lesson was that there are limits to the degree of production fragmentation that was possible or desirable. Benefits of close of communication and costs of transporting goods over long distances and across international borders mean that assemblers or producers of components always prefer, all other things equal, to have subcomponents suppliers close at hand. The degree of local sourcing (or the limits of international fragmentation of production) depends on a trade-off between the centrifugal force of differences in relative production costs and the centripetal force of proximity advantages.

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

The key to the development of local supply networks, however, was not to force their development by imposing local content rules, but rather to facilitate the development of the downstream production in order to create a demand for the products of upstream suppliers. Having chosen to invest in a particular location, internationally experienced and competitive downstream producers then play an important mentoring role for local suppliers with respect to product design, sourcing of materials, production methods and logistics, thus ensuring to the greatest possible extent that they become internationally competitive suppliers.[3]

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

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

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

2.2.2 Mauritius

At independence Mauritius' economic prospects were very bleak.[4] It was among the poorest countries in the world. The population was too high to be supported by the limited land and natural resources available on the island. Any wage sufficient to induce landowners to hire the available labor force would be too low to support even a bare subsistence standard of living. Under existing economic structures, the only hope was in the emergence of technologies that would permit large increases in sugar yields, or significant increases in world sugar prices. Neither of these was very likely. Mauritius appeared to be stuck in a classic Malthusian trap, condemned to grinding poverty, almost inevitable ethnic strife and resulting political and economic instability. It seemed to be a hopeless case.

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

Central to this achievement have been:

- recognition of special opportunities available in world markets, and
- trade promoting policy reforms – facilitation of the import of raw materials and the export of processed products, with the absolute minimum of regulation and conditions attached.

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

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

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

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

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

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

[5] See Box 7 of Flatters 2002b.

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

2.2.3 Summary of General Lessons

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

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

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

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

3. The Functions of Rules of Origin[6]

3.1 General Uses of Rules of Origin

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

The basis for rules of origin in most PTAs is the definition of a minimum level of processing or manufacturing within the region as a requirement for any import from another member state to gain preferential treatment.

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

- Restrictive rules of origin deprive producers of access to raw materials or intermediate products from low cost international sources and hence can raise the cost of producing a product for sale in the PTA.[7] If they have any effect at all, they force producers to source inputs locally when they would not otherwise have done so, forcing them into cost-raising production patterns. This reduces the ability of regional producers to take advantage of

[6] This section draws on Flatters 2002b.

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

regional preferences. In other words, restrictive rules of origin can be used to shield existing producers from new regional competition, and to deprive consumers from potential benefits of regional tariff reductions.

This is sometimes rationalized as a defensive measure to protect producers from cost-raising effects of their own countries' MFN import tariffs on raw materials and intermediate inputs. Forcing potential regional competitors to operate under the same policy-induced handicaps as those in some other member has no economic rationale. At best it makes the PTA irrelevant for globally competitive producers who source materials from the best international sources. At worst, it induces producers to adopt high cost production methods, not for normal economic reasons, but simply to satisfy a rule of origin.

- Strict rules of origin can induce producers to use regional raw materials, thus giving protection and encouragement to the producers of such goods. Such an incentive is necessary only to the extent that their local/regional costs of these materials are higher than international prices of the same goods. Therefore, the burden of rules of origin designed to encourage regional production of raw materials and intermediate inputs will be borne in the form of higher costs by downstream user industries, making them less competitive internationally and forcing them to charge higher prices domestically. Such a strategy can 'work' only if members' external tariffs on finished products are high enough to make it worthwhile to use regional materials when they would not otherwise have been used. In the longer run, however, such a strategy is self-defeating since it reduces rather than increases the global competitiveness of regional producers and deprives consumers of the benefits of trade liberalization.

There is no question that rules of origin can have substantial protective effects. However, to reduce tariffs on regional trade only to replace them with less transparent and often more restrictive rules of origin is a questionable way to achieve the benefits of trade liberalization.

3.2 Proposed Uses of Rules of Origin in SADC

Under some interpretations the SADC Trade Protocol foresees not only the necessary authentication function for rules of origin, but also an additional developmental role. According to the latter interpretation the developmental function is justified by Article 2 of the Trade Protocol which identifies the enhancement of economic development, diversification and industrialization of the region as major goals. Implicitly, as we shall, see this is seen to provide counsel for protection as a development tool, getting to the heart of much more general debates about the role of trade polices in economic development.

Proposed uses of rules of origin in SADC have not been confined to authentication and protection. Others have included enforcement of consumer and industrial safety standards, protection of the regional environment, and preventing the dumping of foreign goods in local or regional markets.

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

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

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

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

In fact, the restrictive rules that are proposed in many cases could not be satisfied by *any* regional producers. Therefore any imports that claim SADC preferences would be known to be illegitimate. No administrative discretion would be necessary.

Solving problems of weak administration by making it impossible for any trade to qualify for SADC preferences subverts the trade liberalization process. Improving administrative systems and capabilities would be a more direct, appropriate and less costly alternative.

3.3 Evolution of SADC Rules of Origin

The rules of origin that were first agreed by SADC and described in the original Trade Protocol were simple, general and consistent with those in other developing country PTAs, including most importantly neighboring and overlapping COMESA.[9] They included both general conditions stipulating that simple packaging, assembly and labeling, for instance, are insufficient to confer originating status (Rule 3 of Annex I to the Protocol), and specific rules setting out minimum levels of economic activity. Under the specific rules goods would qualify for SADC tariff preferences if they underwent a single change of tariff heading, 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 would need to be wholly produced or obtained in the region.

Certain Member States then pressed for exceptions to these rules. As already observed, the arguments for these exceptions were varied, but many of them boil down to attempts to increase protection in domestic markets. This has led to a rule of origin regime in the amended Trade Protocol that is very different from what was originally agreed, characterized by 'made-to-measure' sector-specific rules that are far more restrictive. The change of tariff heading requirement has been replaced by multiple transformation rules and/or detailed descriptions of required production processes. Value added requirements have been raised considerably, and permissible levels of import content have been similarly decreased.[10]

The rules are now much more like those 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 often invoked by special interests in South Africa as models for SADC. Such claims were too often accepted at face value and not recognized as self-interested pleading for protection by already heavily protected domestic producers. There were few questions about the appropriateness of the underlying economic model (whatever it might be) for SADC.

Another factor that might have been influential in shaping the course of SADC's rules of origin is the complex and asymmetric pattern of tariff phase down schedules that was agreed. Undue attention was paid to transitional rules rather than the end product. During the transition it was agreed to permit poorer member states to phase down their tariff rates at a slower rate than richer members (South

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

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

Africa/SACU).[11] Poorer members also agreed and were permitted to phase down preferential tariffs more quickly among themselves than with respect to SACU.[12]

The complexity of the compromises involved in the tariff phase downs made it virtually impossible to reopen discussions later to deal with unforeseen problems.[13] This placed the burden of dealing with any *ex post* complaints of excessively rapid liberalization on other instruments, most importantly rules of origin. Stakeholders wishing to forestall increases in competition arising from preferential tariff reductions found rules of origin to be a wonderful tool. The ability to appeal to the 'EU model' added further credibility to the process of tightening the originally agreed rules.

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

The SADC economies are still heavily dependent on agriculture and on other primary products. For those inclined to see rules of origin as a development tool, these sectors are obvious and important targets. The 'EU model' has provided considerable guidance in this regard.

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

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

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

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

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

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

4.1 Wheat Flour[14]

Rules of origin for wheat flour and its products 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 wholly obtained in the region. At the other extreme are rules that make no reference to the source of the wheat and just

[11] SACU is the Southern Africa Customs Union and comprises Botswana, Lesotho, Namibia, South Africa and Swaziland.
[12] This transitional asymmetry was even carried over into rules of origin in the textile sector.
[13] South Africa's entry into other trade agreements, especially with the EU, together with its commitment in SADC never to offer better preferential access to its markets than to SADC producers added to the difficulty of slowing down or reversing agreed SADC tariff reductions.
[14] The argument in this and the following section is developed in more detail in Erasmus and Flatters 2003.

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 relate to whether there are any requirements on the local wheat content of flour used.

These proposals must be understood against a background of large variations in production capacities and in the regulatory environments for these products in SADC member states. Several members produce significant amounts of wheat, although none are self-sufficient. Others produce almost no wheat at all. South Africa is by far the dominant producer, both in terms of total production and of the proportion of domestic demand that can be met from local production.

Some member states provide considerable protection to local wheat growers and others provide none. Similarly, there are large variations in the amount of protection given to downstream producers of flour and its products. It is useful as well to bear in mind that the regulatory environments facing these industries in some member states, especially South Africa have undergone rapid and significant deregulation in recent years.

Variations in production capacities and in protectionist legacies have led to corresponding differences in policy stances with regard to liberalization of intra-SADC trade in these products. Member states with large and protected wheat and wheat flour industries have tended to resist liberalization of intra-SADC trade. In particular, they have advocated restrictive rules of origin as a means of insulating their producers against competition from other member states.

Even in member states that have resisted liberalization, however, there are significant and growing interests whose focus extends beyond national markets. This is especially true in certain downstream industries. These producers compete in regional and world markets and have a strong interest in a more liberal trading environment. The conditions that permit them to compete in international markets – especially unrestricted access to key raw material inputs – would not apply if SADC markets were governed by high tariffs, stringent rules of origin and other restrictions.

A great deal of the debate about rules of origin in these sectors has centred on wheat. How much is wheat being protected under current arrangements and how might this change as a result of SADC free trade under different rules of origin? Can or should the Trade Protocol be used to promote expansion of wheat growing in SADC? What is the true wheat growing capacity in SADC? The discussion has also been influenced by the well known distortions in international wheat and flour markets arising from protection and subsidy policies in major producing countries.[15]

SADC is not self sufficient in wheat. Outside of South Africa and Zimbabwe, only modest volumes of wheat are produced within SADC. Indeed even South Africa and Zimbabwe need to import wheat in order to meet the requirements of the flour millers. South Africa is SADC's dominant producer, accounting for about 80 percent of total SADC production.

There are also questions about downstream milling industries. In particular, what are the implications of wheat policies on the competitiveness of flour milling in different member states and how might this change as a result of SADC free trade under different rules of origin? Less attention has been paid to the implications of these policies and of alternative arrangements for trade liberalization under SADC for consumers of flour and flour products in member states. The ultimate burden of protection of wheat and wheat flour falls on consumers of these products, especially bread.

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

[15] While these policies might be unfair to SADC wheat producers, they also provide potential benefits to consumers and users of these products in SADC. Generally speaking, the effect of these policies on the world wheat price tends to be considerably overstated in many policy discussions. Regardless of their impacts, however, it needs to be recognized that these distortions in world markets are far beyond the control of SADC or its member states. For the purposes of policy decisions at the SADC level, they might best be treated as exogenous.

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

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

The problem with any rule of origin requiring significant amounts of regionally sourced wheat is that it could never be met by non-SACU millers. Therefore a rule of origin allegedly designed to protect South African millers and grain growers would also prevent all preferential SADC trade among non-SACU members. Only SACU millers would ever be able to satisfy the South Africa-proposed rule.

A closer study of the South African/SACU grain markets reveals another problem with the South African justification for a restrictive rule of origin. In recent years at least, the SACU wheat tariff provides very little if any assistance to local grain growers. Under the competitive structure of the grain market (few buyers, many sellers), domestic wheat prices in South Africa were equal to or less than the import parity price before import duty.[17] In some regional markets they were closer to export parity than to import parity. Simple evidence of this is provided by the preference of non-South African SACU millers to purchase local South African wheat even when they could use the rebate facility to buy imported wheat on a duty free basis.

This means that the South African wheat tariff does not perform its main intended function, to protect domestic wheat growers. Furthermore, it does little harm to flour millers. The only negative impact on millers is the effect it has on the price of imported wheat, which comprises only 20 to 30 percent of their needs.

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

The net protection given to milling industries depends on the effects of tariffs on both wheat and flour. Current MFN tariff structures (those prevailing in early 2002) give substantial protection to millers in most SADC member states. Millers in Malawi and Mauritius get zero effective protection and those in Tanzania get 25 percent. Effective protection to milling in all other member states ranges from 75 to 127 percent.

With a few exceptions, SADC milling industries enjoy considerable protection. Within each market, milling industries tend to be oligopolistic and face little threat from external competition. The opening up of preferential intra-SADC trade, could significantly increase competition, especially from member states with low wheat tariffs. It is in the clear interest of milling industries in heavily protected markets to resist such trade liberalization. The weapon of choice to accomplish this, especially for SACU millers, has been advocacy of a restrictive rule of origin.

Even better still (for the millers) is to delay any possibility of preferential trade taking place. The SADC milling industries have been very good at this. Tariff phase-downs on wheat flour are among the slowest in all sectors. A number of member states have erected non-tariff barriers against imports of wheat flour, the most notable of which is a recently enacted ban on all wheat flour imports in Namibia (a member of SACU). And the milling industries, especially those in SACU, have captured almost complete control of negotiations in this sector and have ensured complete deadlock so that no

[16] While the SACU wheat duty applies to all SACU members, all except South Africa provide a full rebate. The stated purpose of the rebate is to reduce the cost of flour, an important ingredient of many basic foodstuffs.
[17] See Box 2 of Erasmus and Flatters 2003.

rule can be agreed.[18] Claiming to represent the interests of South African wheat farmers against those of non-South African millers, the major South African flour producers have convinced negotiators that any non-restrictive rule of origin will provide a back door through which SADC free trade in flour will destroy the South African grain industry, despite the fact that current protection helps only millers and provides no benefit to grain growers.

Rent-seeking behaviour by key stakeholders has stalled regional trade liberalization in this sector and even to have created new trade barriers. Incorrect but nevertheless plausible sounding claims about support for agriculture have been manipulated to justify policies that provide large returns to particular parties but deliver none of the promised benefits to the alleged target beneficiaries. Rules of origin have been a principal tool in these 'developmental' efforts. As is so often the case, it is the under-represented consumer that pays the price.

4.2 Products of Wheat Flour

Unlike flour, products such as pasta and biscuits are 'two steps removed' in the production chain from the original agricultural raw material – they are products of agricultural products rather than of the raw materials themselves. Nevertheless, some parties have proposed restrictive rules of origin based on requirements to use local raw materials whenever they might be available. Once again it is argued that this will promote demand for local agricultural products.

Good quality European style pasta requires durum wheat – a type that is simply not produced in the climatic and soil conditions prevalent in SADC. Local wheat could be used and some of the deficiencies could be overcome through use of special additives. While this makes it technically possible to produce 'European' type pasta, it is of higher cost and lower quality. The resulting pasta is brittle, and tends to crumble in shipping and storage, before the consumer ever opens the package.[19] Most local pasta producers use flour milled from imported wheat, despite high import duties.[20]

Requiring the use of flour milled from local wheat in order for pasta to receive SADC preferences would make the Trade Protocol irrelevant in this sector. This would suit a producer that currently serves a local SADC market behind very high protectionist barriers designed to protect a new 'infant' pasta factory.[21] Such a restrictive rule of origin would simply 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 that did wish to take advantage of the benefits of free trade in SADC. 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.

As in many other products, the gradual liberalization of trade policies and regulatory regimes, together with increased access to foreign markets has created new international export opportunities for SADC producers in these sectors. A South African biscuit producer has become a competitive exporter in Africa, the Middle East, Asia, Europe and North America. Exports account for a significant and growing share of production, employment and new investment. As with all other internationally competitive producers, an important key to success is skillful sourcing of raw materials.

Quality considerations require that these biscuits use flour milled from wheat that is grown only outside of southern Africa. As with pasta, the only way that local flours could be used would be

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

[19] 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.

[20] 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.

[21] See Box 4 of Erasmus and Flatters 2003.

through the use of additives or use of special processes that would make the products almost impossible to market in the target markets.

A rule of origin requiring a simple change of tariff heading is all that is necessary for these products. A more stringent requirement that products be made with flour milled from regionally grown wheat would make the SADC Trade Protocol irrelevant for this sector, despite the international export competitiveness of a number of regional producers. The only possible 'benefit' might be to eliminate some regional competition for producers supplying some small domestic markets in SADC. This would be harmful to regional consumers and save or create a very small number of regional jobs at best. It would do nothing to promote the much larger investments and numbers of jobs that will arise from the development of internationally competitive producers in the SADC region.

4.3 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 requirements. The raw material producers have tended to have a louder voice and greater influence in the discussions.

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

- increasing demand for a regional agricultural product and hence the incomes of its producers and/or
- 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 some pressure from non-producing member states to relax these requirements 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.

A closer examination of the markets for these products suggests that insistence on highly restrictive rules of origin reflects a fundamental misunderstanding of their likely effects. In the case of spice mixes, many of the relevant spices are not even available in the region, at any cost. Therefore the proposed rules were unlikely to accomplish any of their intended goals, for primary producers or for processors, and would have the unintended consequence of preventing almost all potential intra-SADC preferential trade. They would impede rather than encourage the development of downstream processing activities, at least for the SADC market.

Two of the keys to successful downstream coffee, tea and spice blending are a) sourcing a variety of appropriate raw materials – in terms of quality, price and other characteristics – for blending purposes and b) efficient processing, creative packaging and marketing of the final products. See Box 2 for the case of instant coffee.

2. International Sourcing for Manufacture of Instant Coffee

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

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

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

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.

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

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

Will a restrictive rule of origin encourage downstream processing? No, a restrictive rule of origin for the products in this chapter will not assist in the development of downstream processing industries. In fact, it would most likely have the opposite effect; that is it would decrease the overall competitiveness of coffee, tea, coffee and spice processors.

Processed coffee, tea and spices are heterogeneous and highly differentiated products. The raw materials used are similarly heterogeneous and their characteristics are generally very location-specific – a product of climate, soil conditions and many other factors.[22] Relative to the variety of raw materials available in the world, SADC Member States produce only a very narrow range and a similarly limited set of varieties of the few products that are grown in the region.

Sourcing of raw materials for blending of coffee, tea and spices is a complex process. Producers everywhere, including SADC, source raw materials from all around the world. Buyers and suppliers must be alert to subtle quality differences across space and time; they must also pay close attention to price variations and to supply constraints that arise due changing supply and demand conditions in many different parts of the globe.

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

All other things equal, producers would prefer to source locally – for reasons of transport costs, speedy and reliable communication with suppliers, etc. Local producers work closely with regional suppliers and growers to develop local sources of raw materials where this can be done competitively.

For some products such as rooibos tea, the raw materials can be obtained only in the SADC region. For others, such as Ceylon tea, green tea and many of the spice raw materials that are essential in curries and other mixed spices, there are no local sources of supply in SADC. Branding, licensing, local health regulations and many other factors often determine where inputs must be sourced, and rules of origin cannot be used to overcome these requirements. Where flexibility is possible, however, skillful sourcing and selection of raw materials in the global market is a key to the international competitiveness of these producers. Therefore, restrictive rules of origin simply hinder the development of downstream processing industries. See Box 3 for an example from another sector.

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

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

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

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

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

Restrictive rules of origin would exclude from SADC preferences most of the products currently produced in the region, including many in which non-preferential trade is already taking place. Even member states that might have some comparative advantage in tea, coffee or spice blending by virtue of local availability of some of the necessary ingredients would be deprived of preferential access to SADC markets under current rules. Flexibility in international sourcing of raw materials is essential to international competitiveness. As currently framed, the Trade Protocol will restrict it, at least with respect to preferential trade within SADC. As with wheat and wheat flour, the ultimate cost of restrictive rules of origin on these products will be borne by regional consumers.

5. Manufacturing Industries

5.1 Light Manufacturing

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

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

It was then proposed that the basis for value calculations be changed from *ex*-factory cost to *ex*-works price. According to calculations presented by SACU, this would have the effect, on average, of raising the domestic content threshold from 35 to 45 percent, or lowering permitted non-originating content from 65 to 55 percent. On the other hand, a proposal by a special sub-committee to permit non-originating materials accounting for up to 65 percent of ex-works price remained on the table as well. 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.

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

There are nine four-digit HS chapter sub-headings where a more restrictive 45 percent maximum import content has been agreed, and there remain eleven sub-headings in which no rule has been agreed.

Several justifications were provided for such strict rules. Most were based simply on the desire to protect existing industries against the possibility of increased competition arising from the freer trade in the region. The arguments for protection through restrictive rules of origin range from vague fears of greatly increased and somehow unfair competition, to more subtle defensive arguments based on the high cost of achieving existing levels of local content in the face of protective import regimes.

There were other instances in which member states demanded restrictive rules of origin as a form of insurance, 'just in case' some local manufacturing activity might be threatened under preferential tariff-free access by other members. This insurance was often unnecessary and misguided, not only because it violates the intention of using the Trade Protocol to promote freer trade in SADC, but also because the members in question have no significant local industry to protect anyway.[23]

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

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

The types of industries and firms represented in these sectors cover a very wide range.

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

There are also a significant and growing number of internationally competitive export activities in these sectors. There are examples of intra-industry trade – trade in middle products – 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 much more active players

[23] 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 an investment grant covering almost 100 percent of its capital costs and had not yet even located a piece of land on which to build.

in global markets. This has generated many new jobs for workers in the region – far more in general than can be created in uncompetitive import substitution activities.

Boxes 4 and 5 give examples of the sourcing practices in two sectors, water valves and small electric appliances, which have emerged as competitive export industries as a result of liberalization of the South African economy over the past decade. Although their experience with international sourcing has been quite different, both provide important lessons for the design of rules of origin.

4. ROO and Internationally Competitive Exporters: Valves

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

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

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

5. 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 higher levels of employment than domestically oriented sales. One domestic company now accounts for about 4 percent of the entire global market for electric kettles.

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

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

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

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

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

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

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

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

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

Producers would not voluntarily engage in cost-raising methods of production unless government policies required it and/or unless they were given some financial incentives for doing so. Assembly of products from CKD kits for sale in a protected domestic market is an example of a cost-raising activity encouraged by high tariffs on final products and lower tariffs on kits and components.[24]

The implementation of more restrictive rules of origin raises the serious danger that the Trade Protocol will end up replacing tariffs with rules of origin that rationalize the continuation of policy-induced high cost local content. Far more appropriate would be government policies that encourage and facilitate flexible sourcing of raw materials and intermediate products to foster efficient and competitive manufacturing activities.

Of course, not all increases in local content raise costs. To be able to compete, whether in the local or international market, producers actually would prefer to be able to source raw materials and inputs locally (recall the lessons from Southeast Asia discussed earlier). But to remain competitive, they also must have the flexibility to obtain such materials from the best possible sources, as measured by the net effects of price, quality and other conditions of delivery.[25]

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

In summary, the prohibition of 'screwdriver' assembly operations together with the general chapter rule requiring 40 percent local content relative to *ex*-factory price is more than sufficient for authentication of origin of manufactured goods in these chapters. Additions to these requirements are at best unnecessary, and at worst will serve as a barrier to intra-SADC competition and make the

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

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

SADC market irrelevant for many producers, especially those that are fully engaged and competitive in the international economy.

To impose stricter rules of origin would encourage certain small and inefficient import substitution industries and perpetuate high cost and non-competitive industrial structures. This would be completely contrary to SADC's role in promoting free trade in the region and in becoming a platform to increase the region's competitiveness in world markets.

Two other justifications have been suggested on some occasions for the more restrictive rules of origin proposed for these products. The first is as a means of ensuring the enforcement of consumer and industrial safety standards, and the second relates to the protection of domestic industries against dumping by foreigners.

Without questioning in any way the importance of achieving these social and economic goals, it is clear that rules of origin are not an appropriate instrument. In fact, the use of SADC rules of origin for these purposes would be very costly and almost certainly ineffective.[26]

5.3 Textiles and Garments[27]

Textiles and garments are of particular interest in SADC. This is one of the few manufacturing sectors in which there is significant production in a number of member states. Differences in labor intensity and other determinants of comparative costs at various stages in the textile and garment 'value chain' also mean that there are potentially significant complementarities among member states which, 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. And finally, the opportunities recently opened up through the Africa Growth and Opportunities Act (AGOA) make this a crucial time for remedying domestic and regional policy weaknesses that heretofore have hindered the region's international competitiveness.

As currently agreed, the movement to SADC free trade in textiles and garments is slow, and the sector is subject to 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).[28] With a few exceptions and except for yarn, the rules of origin require double transformation in order to qualify for SADC tariff preferences – garments must be made from regionally produced textiles; fabric must be made from regionally produced yarns; yarn must be made from uncarded, uncombed fibre or from chemical products. The double transformation rules for garments and fabric are waived for the four poorest member states, Malawi, Mozambique, Tanzania and Zambia (commonly known as the MMTZ countries), but only until 2005, and subject to small quotas.

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. The rules of origin are less restrictive than those under AGOA, but nevertheless 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 the constellation of interests in the domestic textile and garment industries in the member states. The general shape of rules of origin was determined before the passage of AGOA and relies heavily on the model of the EU-South Africa free trade agreement.

With a few exceptions the SADC region's textile and garment industries have tended to be inward oriented and uncompetitive in international markets. MFN tariff rates are high, and most sales of domestic industries are in domestic and regional markets. Even within the most heavily protected

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

[27] This section draws heavily on Flatters 2002a.

[28] 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.

markets, however, the ongoing process of trade liberalization, the opening of 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.

Each SADC member state is unique, and so generalizations are difficult to make. Nevertheless, much can be learned by focusing on the dominant players in this sector – South Africa and Mauritius. While these are the dominant players, their different circumstances – the former largely inward looking and the latter much more export oriented – have resulted in quite different interests in and approaches to SADC. Some observations are offered as well on Namibia – until very recently one of the very smallest players in the regional textile industry. See Box 6.

6. 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 labor-intensive garments. At whatever stage they are located in the textile and garment value chain, most exporters rely primarily on imported raw material inputs.[29]

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.

Experience so far is insufficient to demonstrate the capacity to meet the demanding requirements of US and European garment makers; this is not unusual in the face of international experience. Neither simple estimates of aggregate yarn and textile manufacturing capacity nor broad statements of capability and willingness of textile makers to meet garment buyers' demands can be taken as evidence of true capacities to meet the demands that will be forthcoming under AGOA.

For firms that do export, the most important exports are industrial textile products that are assisted considerably by the export incentive and subsidy programs. Even garment exporters are similar to those in Mauritius – i.e. they 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. As observed earlier, her economic success over the past three decades can be attributed in large part to the policy environment which facilitated easy and low cost access to world markets for inputs and outputs. This 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

[29] Stern and Netshitomboni 2001 document the small share of current South African garment exports that currently qualify under the AGOA rules of origin.

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.

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.

The current rules of origin, requiring double transformation in order to qualify for SADC tariff preferences, were formulated prior to the passage of AGOA and so were focused primarily on opportunities for trade among SADC Member States, and not with the rest of the world.

South Africa's stated rationale for the double transformation rule is that it will encourage regional sourcing and deeper integration of the regional textile and garment industries. A closer examination of the South African industry itself, however, shows that there is little such integration. South African garment exporters, and even the majority of producers that sell primarily in the domestic market, use imported fabric. When asked how it would respond to a requirement that its garments be made from domestically or regionally produced fabric, the owner of one of South Africa's most successful garment producers replied: "We could not compete; we would shut our doors tomorrow." This is despite import duties of 40 percent on its products. Another manufacturer of brand name apparel uses Italian cotton fabric for its high end products. Such fabric cannot be obtained from a South African producer at any cost.[30] 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 in most in SADC outside of South Africa.

If not even South African garment producers can satisfy the double transformation rule, why did South Africa insist on enshrining it in the Trade Protocol? There are two plausible answers. One is lack of appreciation of the economic effects of such rules. In early stages of the Trade Protocol negotiations South African officials sought the advice of the textile industry on rules of origin in this sector. As a quick response, industry representatives proposed existing EU rules. Despite their obvious inappropriateness for SADC, enshrining these rules in South African agreements with the EU gave them an air of respectability that was unquestioned in both the industry and the South African government.

The second possible reason for South Africa to propose rules that could not be met by their own industry lies in the structure of their MFN tariff protection of textiles and garments.[31] South African garment makers that sell in the domestic market and hence do not benefit from duty rebates or duty credit certificates (DCCs) suffer from the cost-raising impact of high fabric import duties, generally in excess of 20 percent. At the same time, they are more than adequately compensated for this by much higher import duties on garments, generally in excess of 40 percent. The net effect is very high rates of effective protection when selling domestically.

[30] See Box 3 of Flatters 2002a.
[31] See Box 4 of Flatters 2002a.

The double transformation rule of origin is designed, not really to encourage use of regional textile inputs (not even South African garment makers do so at the moment), but rather, to ensure that SADC preferential trade does not take place when South African garment makers labor under their own government's policy handicap of high textile duties. The same explanation applies one stage further back in the production chain.

As long as they are penalized by high duties and other restrictions on yarn and fibre imports, South African textile makers do not want duty-free competition from regional weaving and knitting industries that have access to duty free yarn. A double transformation rule of origin 'solves' this problem by ensuring that such competition will never occur.

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

As observed earlier, SADC arrangements for the textile and garment sector were agreed prior to and without reference to AGOA. Will the Trade Protocol assist in taking advantage of this unique opportunity?

AGOA offers extended GSP privileges for a wide range of African products to the US market for the period ending in 2008. Among the most important sectors is textiles and clothing.[32] The typical U.S. MFN import duties on garments currently exported from the region are in the range of 17 to 20 percent.

On the other hand, the AGOA rules of origin require that most garments be made from yarn and textiles produced in the region or the US ('yarn forward' rule). This requirement is temporarily waived for the least developed qualifying countries, which will be permitted to source cloth anywhere for AGOA garment exports, but only until September 2004.

This rule of origin is a double-edged sword.

- In the absence of regional capacity to produce textiles of adequate quality, quantity and price, the rules of origin will prevent the region from taking full advantage of the AGOA export opportunities.
- On the other hand, the rules of origin provide a tremendous incentive to increase and improve regional capacities in textile production.

These rules of origin are exogenous to SADC Member States. They are the outcome of negotiations among conflicting US interests. On the one hand, garment buyers and American pro-Africa lobbies would prefer relatively unrestrictive rules in order to make Africa as low-cost a supply source as possible and to maximize the employment creating and development possibilities from access to the US market. On the other hand, American textile sector producer and labor interests prefer stricter rules in order to minimize African competition and consequent 'market disruption' in their domestic markets.

Limitations in regional yarn and fabric production capacities have already been identified as a serious impediment to the region's ability to take advantage of AGOA (Coughlin, Rubin and Darga 2001; Stern and Netshitomboni 2001). However, early AGOA experiences with Mauritian garment exporters and US garment buyers suggest that there is room for considerable regional collaboration among buyers, garment exporters and yarn and textile producers to develop regional capacities, especially among existing companies in South Africa.

[32] In an analysis of possible opportunities provided to South Africa, Stern and Netshitomboni 2001 show that almost all goods currently exported from South Africa to the US that might be significantly tariff-constrained are in these sectors (Table 1).

US buyers, together with garment producers in a number of SADC Member States and other countries in the region, have a very strong interest in seeing the South African textile industry achieve its potential to supply the US market. International experience suggests that the capacity to produce fabric of the high quality, low cost and reliable delivery under the tight time schedules demanded by US and European garment buyers takes a long time to develop. The demands that are being created by AGOA are a strong and very useful stimulus to develop these capacities in South Africa and elsewhere. What is needed above all to capitalize on these new opportunities is ease of trade, transport and communication among SADC Member States (and with key non-members such as Madagascar). Tariffs, and bureaucratic regulations associated with strict SADC rules of origin will hinder, not assist, in exploiting the potential of AGOA.[33]

Even without regional trade and cooperation there is still room for rapid mobilization of capacity to capitalize on opportunities in AGOA. Recently announced investments in weaving capacity in Lesotho are directly linked to AGOA opportunities. Even more impressive is the large new investment in an integrated spinning, knitting dying and finishing, and garment production by a Malaysian company, Ramatex, in Namibia.[34]

The Ramatex factory, the company's largest in the world, will produce a variety of types of clothing and sportswear in Namibia, and will sell the products through an established network of American customers. It will employ thousands of workers. Related companies producing sportswear for American sports brands have built adjoining factories that utilize inputs produced at the main factory. The integrated operation will be able to meet AGOA rules of origin from this one source. Fibre inputs, dyestuffs, finishing and other materials will be sourced from the company's global operations. As the operation matures, however, they will develop or encourage the development by others of local complementary activities such as packing materials.

The Ramatex example shows that SADC is not necessary for member states to take advantage of AGOA. But it also demonstrates that in the absence of SADC integration, existing companies in the region will have far less to gain.

What can be concluded about the rule of origin regime for SADC in this sector? For export-oriented garment and textile production, any SADC rules of origin are:

- redundant in the face of restrictive rules imposed by AGOA (and EU) and/or
- unnecessary and almost certainly cost-raising where exports are not constrained by such rules in export markets.

The stringent rules of origin and backloaded tariff reduction schedules that are currently agreed for textiles and garments will be especially unhelpful to SADC as a means of taking advantage of AGOA.

To take advantage of international export opportunities, producers at any place in the garment and textile value chain would benefit from 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.

For regionally-oriented garment production, the restrictive SADC rules of origin will achieve the opposite of what is intended. They hinder rather than promote regional vertical integration. They restrict tariff preferences only to integrated spinning and weaving/knitting operators that operate in member states with high MFN tariffs on these products.[35] And they impose conditions on garment producers that cannot be met even by South African garment makers when producing for their own highly protected domestic market.

The main effect of the current rules of origin will be to ensure that South African producers face no competition from non-SACU SADC producers. This is motivated, in part, by the heavy cost penalties imposed by South Africa's protective MFN tariffs on raw material inputs.

[33] See Box 1 of Flatters 2002a.
[34] See Box 2 of Flatters 2002a.
[35] See Box 5 of Flatters 2002a.

The Trade Protocol in this sector has been dominated by an inward-looking, fortress vision of SADC. Without a rapid and convincing change in this vision, the SADC textile and garment sector will cripple itself by removing a vehicle for capitalizing on the unique and time-limited opportunities offered by AGOA. Taking advantage of AGOA will be difficult in the best of circumstances. To try to do so in the face of self-imposed policy handicaps is a self-defeating way to try to meet the challenge.

6. Conclusion

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

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

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

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

To impose restrictive rules of origin in a large and technologically sophisticated market such as the EU is one thing. However, the entire SADC market is smaller than Turkey and its industrial structure is still thin and undiversified. To burden SADC producers with the constraints of such rules in this market is not a sensible development strategy. The best it can do is to make SADC irrelevant in increasing the participation of its members in world markets.[36]

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

[36] See Flatters 2001 for further discussion.

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