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ECONOMIC DEVELOPMENT IN AFRICA REPORT 2019

Made in Africa

Rules of origin for enhanced intra-African trade

UNITED NATIONS

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Economic Development in Africa Report 2019

Made in Africa – Rules of Origin for Enhanced Intra-African Trade

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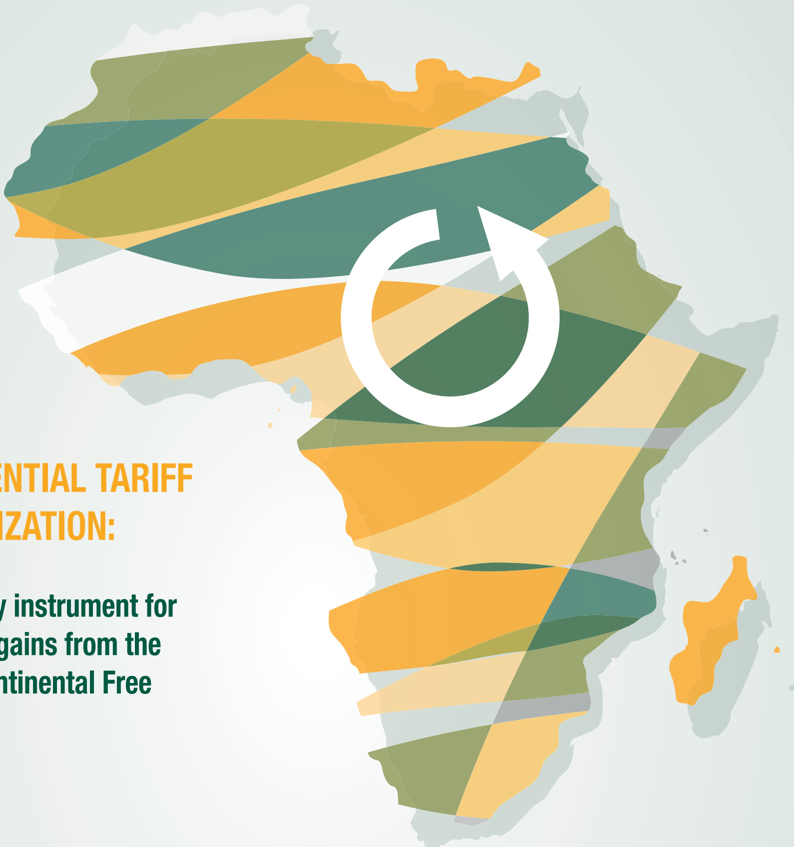
Chapter 1

On the road to the African Continental Free Trade Area: Challenges and opportunities

1.1 Introduction: Challenges, opportunities and the role of rules of origin

This edition of the *Economic Development in Africa Report* focuses on the role of preferential rules of origin (henceforth rules of origin) in shaping the development of regional value chains in the African Continental Free Trade Area, with the objective of maximizing gains from the Continental Free Trade Area for structural transformation. Chapter 1, section 1.2 situates the role of rules of origin within the vision of the Abuja treaty and Agenda 2063 of the African Union. Section 1.3 analyses the state of trade and related impediments to trade in Africa, which will influence the magnitude of the potential gains that rules of origin and regional value chains may generate. Section 1.4 discusses the potential gains from the Continental Free Trade Area and a few of the factors that can affect these gains, in addition to rules of origin. Section 1.5 makes the economic case for rules of origin as a critical factor in the effectiveness of preferential tariff liberalization as a policy instrument to achieve the objectives of the Continental Free Trade Area. Section 1.6 concludes the chapter.



PREFERENTIAL TARIFF LIBERALIZATION:

Main policy instrument for delivering gains from the African Continental Free Trade Area

RULES OF ORIGIN:

Ensure gains accrue to Africa, provided certain conditions are met

- Competitive input costs
- Productive capacities
- Sophisticated products
- Efficient business and trade facilitation

1.2 The vision of the Abuja treaty, regional value chains and the African Continental Free Trade Area

The establishment of the African Continental Free Trade Area, one of the flagship projects of Agenda 2063, represents a critical step in the journey of Africa towards the operationalization of an integrated market that is meant to culminate in the formation of an African economic community, in accordance with the Abuja treaty. The signing of the Agreement Establishing the African Continental Free Trade Area is a landmark historical achievement that signals the crossing of an important milestone in the continent's long regional integration history.

Two of the four objectives of the African economic community as stated in the Abuja treaty are to "promote economic, social and cultural development and the integration of African economies in order to increase economic self-reliance and promote an endogenous and self-sustained development" and "to coordinate and harmonize policies among existing and future economic communities in order to foster the gradual establishment of the community".

To achieve the final objectives of the regional integration process in Africa, the effective operationalization of the Abuja treaty requires the implementation of complementary strategic continental initiatives and programmes, such as the Comprehensive Africa Agriculture Development Programme, the Programme for Infrastructure Development in Africa of the New Partnership for Africa's Development, the action plan of the Accelerated Industrial Development for Africa initiative of the African Union and the Action Plan for Boosting Intra-African Trade of the African Union. Coherence in vision, along with the timely implementation of multiple continental programmes, such as those cited, is central to ensuring that regional integration delivers on its stated overarching goals.

Regional integration that solely emphasizes the removal of tariff and non-tariff barriers, on its own, cannot deliver on the stated goals of promoting sustainable development for the continent, but should be accompanied by the building of productive capacities, the acceleration of structural transformation and the unleashing of the potential of the private sector. Critical requirements include fostering domestic entrepreneurship, domestic resource mobilization, political stability and peace, and establishing appropriate institutional structures and mechanisms to ensure an equitable distribution of socioeconomic costs and benefits across all 54 countries in Africa in a way that is politically acceptable to all.

Developmental regionalism (a development-based approach to regional integration) in Africa is necessary to ensure sustainability in the continent's regional integration process, in order for it to culminate in the creation of an African economic community (UNCTAD, 2013). Africa needs deeper integration that goes beyond preferential tariff liberalization alone.

Regional integration in Africa is not meant to be an agenda for trade and investment protectionism, intended to build the competitiveness of Africa behind walls and to significantly scale down the continent's development partnerships with external trading partners. Self-reliance and endogenous self-sustained development are the overarching goals of the continent's regional integration process, yet it is imperative for countries in Africa, in particular the 33 LDCs, to continue to take advantage of the special and differential treatment provisions of the World Trade Organization (WTO) under, for example, the African Growth and Opportunity Act of the United States of America and the Everything But Arms initiative of the European Union and many other bilateral preferential agreements and free trade agreements (with, for example, China and India), to boost the share of African trade in the global economy. Regional integration in Africa should be a launch pad to deepen integration in the world economy by accelerating the building of productive capacities and competitiveness among African enterprises. The African Continental Free Trade Area, which will be the largest free trade area since the formation of WTO in terms of the number of participating countries, marks a pivotal shift for Africa in terms of accelerating trade, investment and industrialization within the continent and strategically leveraging Africa as a key economic player on the global stage.

The end goals of self-reliance and endogenous self-sustained development necessitate the implementation of a range of policy tools and instruments, central to which is the development of regional value chains in Africa, within the broad industrialization agenda of Africa.

A critical policy instrument that can shape both the size and distribution of economic gains to countries in Africa, generated within regional value chains and the industrialization strategy of Africa, is preferential trade liberalization. The role of rules of origin is to ensure that gains from preferential trade liberalization accrue to the members of the African Continental Free Trade Area. This report argues that rules of origin within the Continental Free Trade Area should be purposefully crafted and enforced in such a way as to support and shape the development of regional value chains on the continent and foster industrialization and structural transformation, with the final aim of maximizing the gains from the Continental Free Trade Area. How rules of origin and preferential trade liberalization are addressed in the Continental Free Trade Area will directly affect the size and distribution of economic benefits among member countries and, ultimately, the political will of members to advance regional integration to create an African economic community.

The raison d'être of regional trade agreements is to provide members with preferential access, relative to non-members, to the markets of all member countries and, in so doing, support regional trade in intermediate and final goods. To be eligible for the preferential tariff rates that apply only to members when exporting under regional trade agreements, each member country must meet a set of eligibility requirements, which include the requirements of an originating status clause, whereby the goods traded, or a certain percentage of the contents of the goods traded, must originate within the regional trade area.

This requirement is critical for the following two reasons: to ensure that preferences accrue only to members and are not deflected to non-members, i.e. to avoid trade deflection and trans-shipment; and to ensure that preferences contribute to stimulating local production and the sourcing of intermediates from within the regional trade area rather than the rest of the world, so as to result in increased net trade among members, i.e. to promote net trade creation. Without an originating status clause, the economic benefits to regional trade area members are diminished, undermining the political will to remain in an agreement, while the objectives of regional trade agreements (e.g. regional industrialization, regional structural transformation, regional economic diversification and enhanced regional trade) are undermined. In other words, the originating status concept is fundamental to delivering on the potential benefits of agreements to member countries. Under regional trade agreements, the only way to certify where goods have originated is by establishing rules of origin. The message is clear: there can be no economic benefits accruing to regional trade area members unless rules of origin are properly defined and credibly enforced within the regional trade area. Rules of origin are thus the cornerstone of the effective application of preferences towards regional trade area members. Moreover, rules of origin are necessary for preferential trade liberalization and are critical to the development of the African Continental Free Trade Area. Box 1 provides a general definition of rules of origin (see chapter 2 for details on the technicalities behind rules of origin and a mapping of rules of origin in regional economic communities and under other preferential trade arrangements in Africa).

The raison d'être of preferential rules of origin is the avoidance of trade deflection, yet actual practice under regional trade agreements has diluted this objective, and rules of origin are increasingly becoming an economic, political and trade-related instrument (Abreu, 2013).

Challenges in implementation can affect the benefits that rules of origin should bring to a regional integration process in terms of increased intraregional trade, increased economic diversification, faster industrialization and deeper structural transformation. There are compliance costs associated with rules of origin with regard to verifying and enforcing compliance with originating status criteria and procedures, and such costs also vary according to the different types of rules of origin (Mizuno and Takauchi, 2013).

Box 1
What are rules of origin?

Rules of origin are the rules for determining the country of origin of goods. According to UNCTAD, “rules of origin are like a passport for a product to enter a free trade area and circulate without being imposed a duty”. The World Customs Organization states that “the basic role of rules of origin is the determination of the economic nationality as opposed to the geographical nationality of a given good” and also states as follows: “The rules of origin are used as an important trade measure. They do not constitute a trade instrument by themselves and are not to be used to pursue trade objectives directly or indirectly or as a policy measure. The rules of origin are used to address different commercial policy instruments and they can be used to attain specific purposes of national or international policies.”

Sources: UNCTAD, 2016c; World Customs Organization, 2012.

The effectiveness of rules of origin in delivering sizeable economic benefits to countries in Africa under regional trade agreements depends on a range of factors that include cost competitiveness in sourcing inputs among regional trade area members compared with sourcing from non-members. Cadot, Estevadeordal et al. (2006) note that “if rules of origin impose the use of expensive local materials and burdensome administrative procedures to confer originating status, they can also render the preference margin worthless” and that “stringent rules of origin can prevent the smooth operation of cross-border supply chains or foster the emergence of inefficient ones”. For the African Continental Free Trade Area to deliver economic gains to member countries through the development of regional value chains, in a politically sustainable way that ensures the long-term viability of regional integration, many countries must participate. However, such participation is contingent on improved production competitiveness conditions within member countries, compared with conditions in non-members. There are a set of preconditions to be met in order for rules of origin and preferential trade liberalization to deliver on the goals of developing regional value chains and generating economic benefits large enough to be equitably distributed across a range of member countries. Such preconditions include the implementation of trade and business facilitation measures in participating countries and measures to build productive capacities and enhance product sophistication. A few of these preconditions are discussed in greater detail in section 1.3.

1.3 The state of trade in Africa: Key impediments and prospects

Africa is a marginal player in the global trade in goods. Total trade from Africa to the rest of the world averaged $760,463 million in current prices in the period 2015–2017, compared with $481,081 million from Oceania, $4,109,131 million from Europe, $5,139,649 million from America and $6,801,474 million from Asia.[5] Figure 1 shows the total trade trends for each region in 2000–2017.

Africa was adversely affected by the recession in 2008 and its aftermath, reflecting the high dependence of the region on trade with the rest of the world. Regional trade can help reduce the vulnerability of the continent to external forces. More concretely, the share of exports from Africa to the rest of the world ranged from 80 to 90 per cent in 2000–2017. The only other region with a higher export dependence on the rest of the world is Oceania. Conversely, the share of intraregional exports in total exports is lowest in Africa, compared with other regions, except Oceania. Intra-African exports were 16.6 per cent of total exports in 2017, compared with 68.1 per cent in Europe, 59.4 per cent in Asia, 55.0 per cent in America and 7.0 per cent in Oceania.[6]

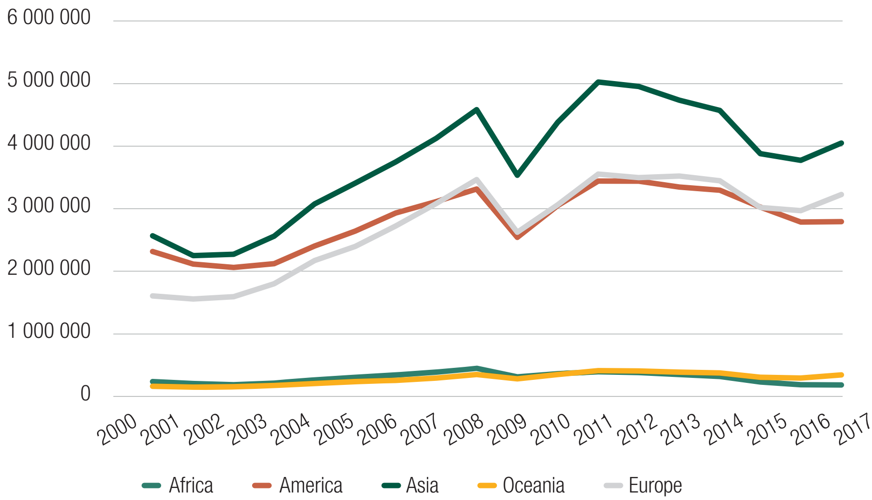
[5] Trade in this section refers to merchandise trade unless otherwise stated. Regional classifications in the UNCTADstat database are Africa, America, Asia, Europe and Oceania.

[6] UNCTAD calculations, based on the UNCTADstat database.

Figure 1

Trade (exports and imports, all products) to rest of world by region

(Millions of dollars (constant 2000 prices deflated by consumer price index of each region))



Source: UNCTAD calculations, based on the UNCTADstat database.

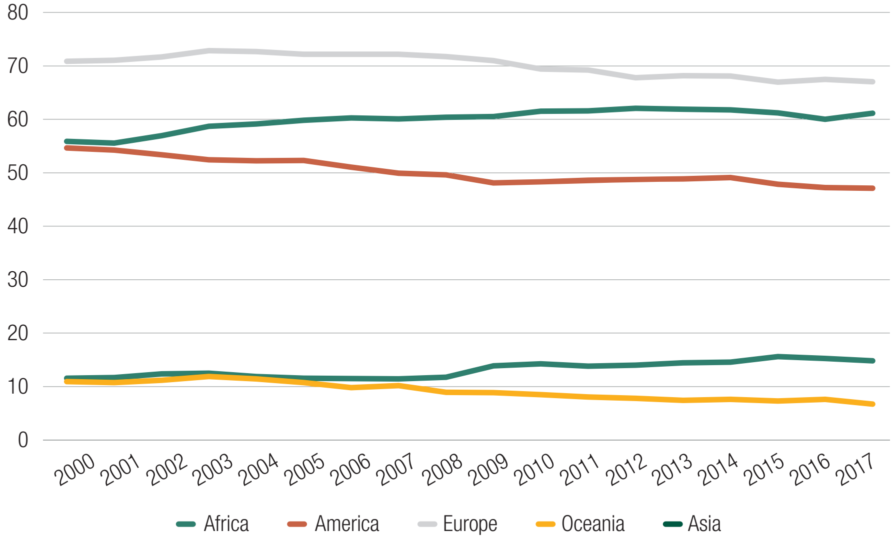
Intra-African trade, defined as the average of intra-African exports and imports, hovered at around 15.2 per cent in the period 2015–2017, while comparative figures for America, Asia, Europe and Oceania were, respectively, 47.4, 61.1, 67.1 and 7.2 per cent (figure 2). Africa, along with Asia, is the only region with a rising trend in intraregional trade from 2008.

In interpreting shares of intra-African trade in total trade, there are three caveats. First, there is evidence to suggest that intra-African trade may be subject to double counting, amounting to 7 per cent of intra- regional economic community exports and 9 per cent of intra-regional economic community imports, owing to overlapping memberships (Chidede and Sandrey, 2018). Second, intra-African trade is likely to be underestimated due to the prevalence of informal trade. Third, increases in intra-African trade may not necessarily be welfare-improving if most intraregional trade displaces cheaper extraregional trade (i.e. the trade diversion effect). For intra-African trade to be welfare-improving, the trade creation resulting from increased intra-African trade must be greater than trade diversion.

Figure 2

Intraregional merchandise trade (all products) by region

(Percentage)



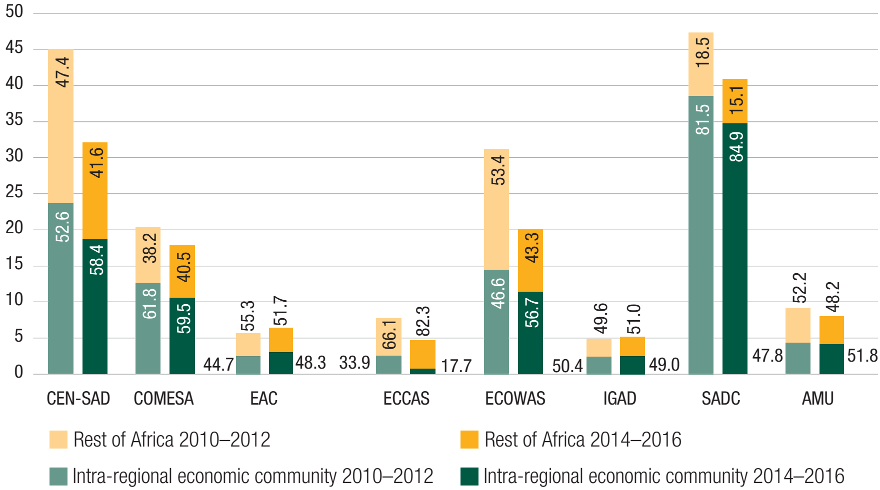
Source: UNCTAD calculations, based on data from Harvard University, 2018.

There are eight regional economic communities in Africa, yet the share of intra-African trade remains low, at around 14.8 per cent in 2017. Figure 3 shows a comparison of levels of trade in the communities. In 2016, intra-regional economic community trade was highest in SADC ($34.7 billion), followed by CEN–SAD ($18.7 billion), ECOWAS ($11.4 billion), COMESA ($10.7 billion), AMU ($4.2 billion), EAC ($3.1 billion), IGAD ($2.5 billion) and ECCAS ($0.8 billion). With regard to the share of intra-regional economic community trade in total trade in Africa, in 2016, there were deeper levels of integration in SADC (84.9 per cent), followed by COMESA (59.5 per cent), CEN–SAD (58.4 per cent), ECOWAS (56.7 per cent), AMU (51.8 per cent), IGAD (49.0 per cent), EAC (48.3 per cent) and ECCAS (17.7 per cent).

Figure 3

Intra-regional economic community trade in Africa, 2010–2012 and 2014–2016

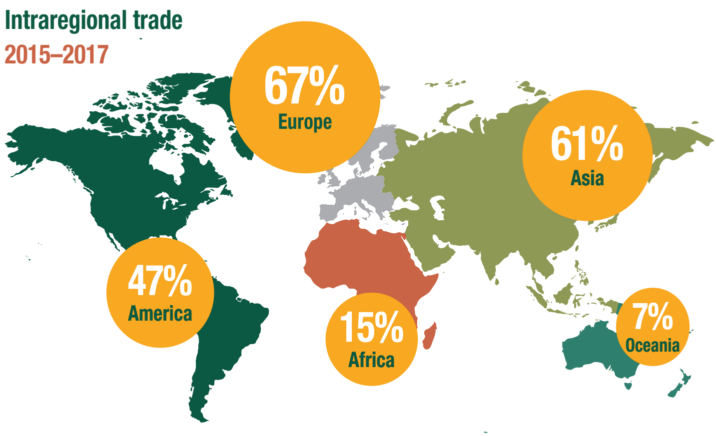
(Billions of dollars and percentage of total African trade)



Source: UNCTAD calculations, based on data from Harvard University, 2018.

The level of intra-regional economic community trade in Africa differs between communities, reflecting economic factors such as differences in stages of industrial and economic development and degrees of complementarity in production structures; differences in the state of political relations among member countries; and varying levels of political commitment towards the implementation of the agreements underpinning the regional economic communities. Progress towards the regional integration of Africa has been uneven to date, with some countries fairly well integrated at the regional and/or subregional level and others much less so. The 10 leading intra-African exporters in 2015–2017 were Swaziland (70.6 per cent), Namibia (52.9 per cent), Zimbabwe (51.6 per cent), Uganda (51.4 per cent), Togo (51.1 per cent), Senegal (45.6 per cent), Djibouti (41.9 per cent), Lesotho (39.9 per cent), Kenya (39.3 per cent) and Malawi (38.3 per cent). The 10 countries with the lowest share of exports were Chad (0.2 per cent), Guinea (1.6 per cent), Eritrea (2.3 per cent), Equatorial Guinea (3.5 per cent), Cabo Verde (3.6 per cent), Angola (3.9 per cent), Libya (4.5 per cent), Guinea Bissau (4.7 per cent), Liberia (5.1) and Algeria (5.5 per cent).[7]

[7] UNCTAD calculations, based on the UNCTADstat database.



Countries that have more diversified exports tend to have higher shares of intra-African exports than countries that have less diversified exports. Simple correlation coefficient calculations between the shares of intra-African exports and UNCTAD product concentration indices at the country level for the period 2015–2017 show a negative association of 0.53.[8] This indicates that the more concentrated the index, the lower the share of intra-African exports in total exports for a given country. Diversifying the range of goods produced within countries in Africa creates greater possibilities for intraregional trade.

With regard to the product and sectoral composition of intra-African trade, the continental market remains limited in size, yet intra-African exports appear to be more diversified and less primary commodity-dependent than exports from Africa to the rest of the world. Mineral products (petroleum, ores, etc.) account for 33 per cent of intra-African exports and constitute 50 per cent of total exports from Africa to the rest of the world (figure 4). The concentration of exports to the rest of the world on mineral products is also markedly evident at the regional economic community level. At the aggregate level, in 2015–2017, exports of manufactures accounted for 45 per cent of intra-African exports, but only 20 per cent of exports from Africa to the rest of the world.

With regard to product complexity, Hausmann and Hidalgo (2011) state that the process of economic development involves the accumulation of capabilities or productive

[8] The UNCTAD product concentration index shows the degree to which the exports and imports of individual economies or groups of economies are concentrated on a few products rather than being distributed in a more homogeneous way across several products. The correlation coefficient was statistically significant at a 1 per cent level.

knowledge that allows a country to produce a diverse range of increasingly complex products. Products differ by the level of complexity that is required for their production. Higher levels of complexity are strongly correlated with a higher level of income in a country, and variations in economic complexity in certain products can be predictors of future overall growth for a country. Countries that increase the production and trade of products with an above average complexity, are more likely to experience higher growth in the future. Given the economic complexity of each economy, a product complexity index can be derived by comparing, for a given product, the complexity of the country producing that product. The product complexity index can infer information about a country's productive capabilities from its export basket, helping to explain differences in GDP per capita between countries and to predict economic growth.

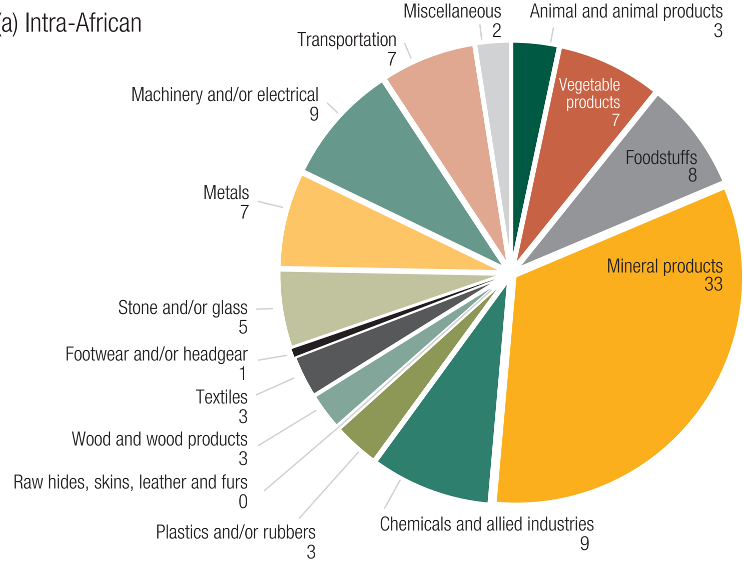
Figure 5 shows the average trade-weighted product complexity index for all countries in Africa in 2010–2012 and in 2014–2016 for trade within Africa and with the rest of the world. The line shows the 45-degree angle; countries above this line have a higher product complexity in their trade flows within Africa than with the rest of the world. As shown in the figure, this is true for most countries in Africa in both periods. This is coherent with the well-established finding that intra-African trade is more intensive in manufactures than trade between Africa and the rest of the world; the latter is dominated by primary commodities. Manufactures in general have higher levels of product complexity than primary commodities. The Democratic Republic of the Congo, Djibouti, the Niger and Seychelles are notable exceptions in both periods. The African Continental Free Trade Area is expected to lead to an increase in intra-African trade flows, and African trade flows could therefore increase in products of relatively higher complexity, which could in turn lead to potentially higher economic growth in the future.

Figure 4

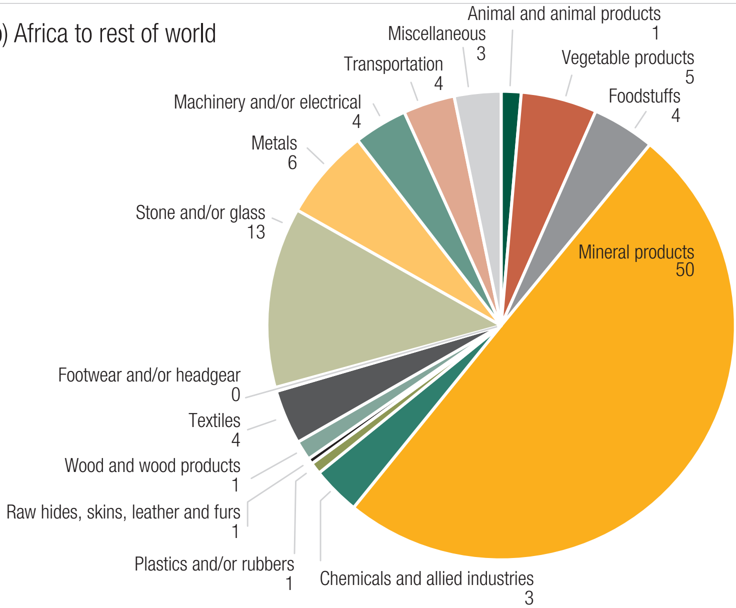
Composition of exports from Africa, 2014–2016 average

(Percentage)

(a) Intra-African



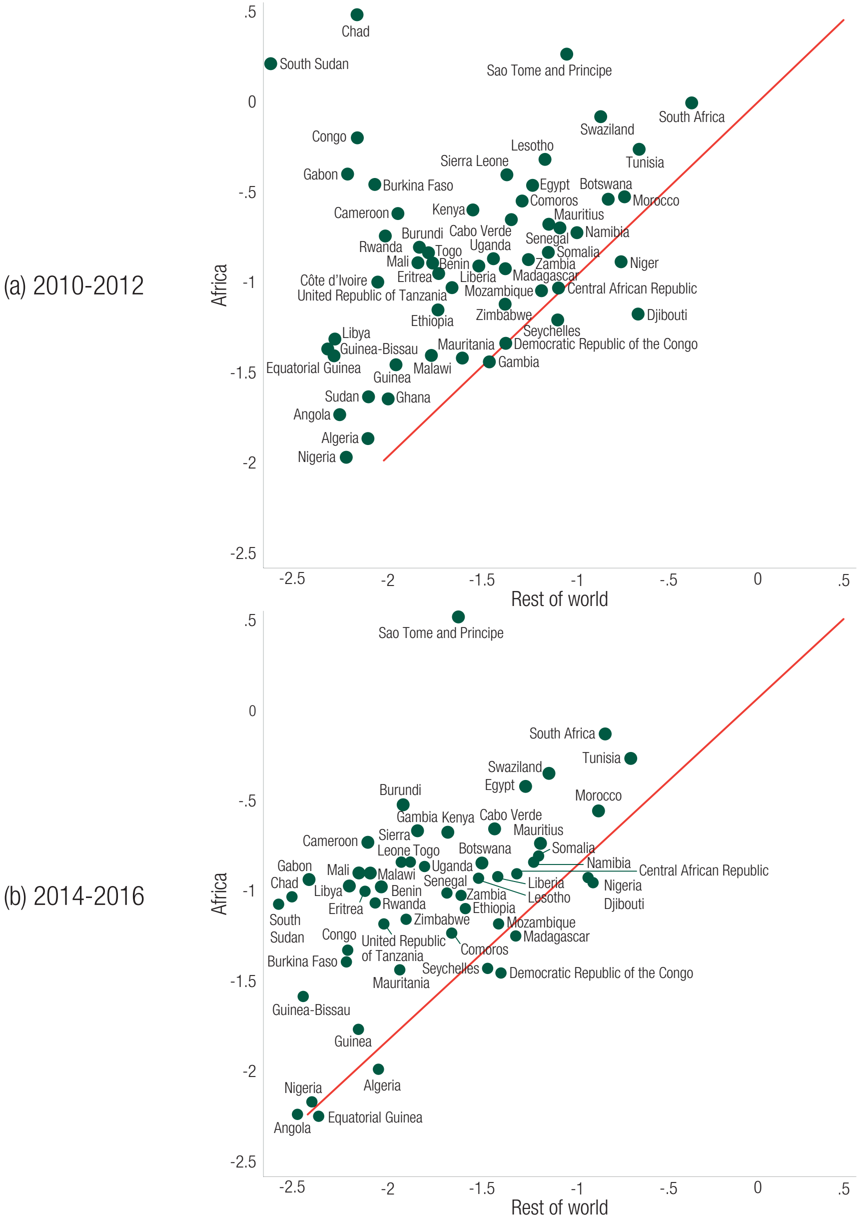
(b) Africa to rest of world



Source: UNCTAD calculations, based on data from Harvard University, 2018.
Note: Exports at Harmonized Commodity Description and Coding System (HS) four-digit level.

Figure 5

Product complexity index, weighted by trade flows, 2010–2012 and 2014–2016



Source: UNCTAD calculations, based on data from Harvard University, 2018.

The economic complexity index provides "a rank of countries based on how diversified and complex their export basket is. Countries that are home to a great diversity of productive know-how, particularly complex specialized know-how, are able to produce a great diversity of sophisticated products".[9] The index provides a measure of the ability of a country to apply knowledge to produce a range of diversified goods that are complex. Based on the data available for 31 countries in Africa in 2016, the leading 10 countries on the index were Tunisia, Egypt, South Africa, Mauritius, Uganda, Namibia, Mali, Morocco, Senegal and Kenya. Simple correlation coefficient calculations between the economic complexity index and manufacturing value added per capita (at constant 2010 dollars) in the 31 countries show a statistically significant (at a 1 per cent level) positive association of 0.53. In general, countries that have higher levels of manufacturing value added per capita have a higher economic complexity index score. This result is to be expected, given that the manufacturing sector involves the production of more complex products than the non-manufacturing sector. For countries with higher levels of manufacturing development, this suggests a greater initial role in leading in the development of regional value chains on the continent.

There is significant scope to enhance inter-regional economic community trade in Africa. Most of the African trade in regional economic communities takes place either within communities (intra-regional economic community trade) or with another community, rather than being fairly distributed across the remaining communities (inter-regional economic community trade). Trade interactions among the eight communities tend to be concentrated among a few groups, and there is scope to enlarge inter-regional economic community trade. The African Continental Free Trade Area can provide a platform of dialogue and negotiations across all eight regional economic communities, allowing communities to increasingly trade with one another to accelerate harmonization and coordination among them, as stipulated in the objectives of the Abuja treaty, and to strengthen their roles as building blocks of the African Continental Free Trade Area.

The African Continental Free Trade Area can boost intra-African trade by increasing the economic viability of industrialization on the continent and accelerating structural transformation, with commensurate positive effects on product diversification. The development of regional value chains in Africa depends on the implementation of national and regional industrial policies that promote diversification in the range of goods produced, both intermediate and final. The higher the level of product diversification in Africa, and the more cost competitive the production relative to external competitors, the greater the incentives for countries in Africa to implement and enforce rules of origin incentivizing the sourcing of inputs within Africa. Without adequate levels of product diversification and competitiveness, the expected benefits of rules of origin may be

9 See http://atlas.cid.harvard.edu/learn/glossary.

diminished, given that producers in Africa may find it cheaper to source inputs abroad or find it difficult to source the inputs they need within the relevant regional trade area to engage in production.

Building industrial productive capacities and competitiveness takes time. In the short term, therefore, rules of origin that are too restrictive (i.e. requiring a large portion of inputs to be sourced from within a regional trade area or imposing several stages of transformation to allow member countries to qualify for reduced duties) can deter regional trade or create trade diversion, that is, divert trade from less costly suppliers from outside a regional trade area to costlier supplies within. Therefore, rules of origin should be less restrictive and less complex at the initial stages of implementation of the Agreement Establishing the African Continental Free Trade Area, as many member countries have weak institutional capacities, low levels of competitiveness and limited capabilities to participate in regional value chains due to insufficient productive capacities for supplying sourced inputs. Simplified, flexible and lenient rules of origin are needed, in particular for LDCs in Africa, in the early stages, to help kickstart regional industrial production. The rules of origin regime can increase in complexity and restrictiveness gradually, once member countries have reached a threshold level of competitiveness and productive capacities, whereby they can satisfy the eligibility criteria set by more complex rules of origin to qualify for preferential treatment.

At higher levels of competitiveness, product sophistication and product diversification, more complex and restrictive rules of origin can boost regional trade, accelerate the development of regional value chains and ensure that a larger share of the value added and rents created during production is retained within a regional trade area. The degree of complexity and restrictiveness in rules of origin should consider the levels of product diversification, sophistication and competitiveness in member countries; too restrictive and complex rules of origin at low levels of regional productive capacities can provide incentives to member countries to trade outside a regional trade area rather than within. Such incentives may be greater for small and/or low-income countries such as LDCs, in which productive capacities and competitiveness levels may be lower. For example, LDCs, with assistance from UNCTAD, have expressed concerns at WTO about the challenges they face in complying with rules of origin under duty-free, quota-free schemes (WTO, 2014). One concern relates to the design of rules of origin not having followed developments in world trade. Their design should be context specific, that is, specific to the time, sector and industry, since the design of rules of origin should consider the specificities of the product sector to which they will apply and the constraints faced by firms in the sector, including challenges arising from changing regional and global environments. Such factors will influence the costs of compliance with rules of origin.

1.3.1 Key impediments to trade in Africa

The gains from the African Continental Free Trade Area can potentially be numerous, but are not automatic. One of the major goals is to boost intra-African trade. Besides the challenges of implementing the Agreement Establishing the African Continental Free Trade Area and progressively liberalizing tariffs on goods, there are obstacles to trade in Africa independent of tariff liberalization. The major impediments to trade have been identified in the Action Plan for Boosting Intra-African Trade of the African Union, which states that "the growth of intra-African trade has been constrained by a number of factors. These include differences in trade regimes; restrictive customs procedures, administrative and technical barriers; limitations of productive capacity; inadequacies of trade-related infrastructure, trade finance and trade information; lack of factor market integration; and inadequate focus on internal market issues" (African Union, 2013).

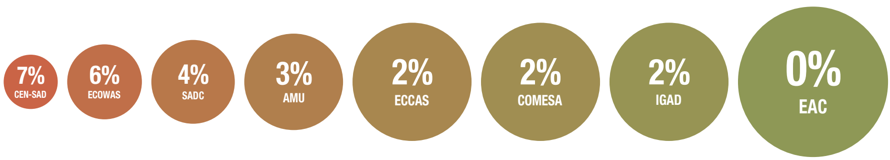
There are three major categories of obstacles to intra-African trade, namely, weak productive capacities and limited economic diversification, which constricts the range of intermediate and final goods that can be traded and potentially inhibits the fuller development of regional value chains; tariff-related trade costs, associated with the slow implementation of the tariff liberalization schedules underpinning free trade agreements; and high non-tariff-related trade costs that hamper the competitiveness of firms and economies in Africa. Such high trade costs, related to business and trade facilitation, can be explained in terms of the hard and soft infrastructure deficits in Africa that have an impact on transport and transit costs and at-the-border and behind-the-border costs (UNCTAD, 2009; United Nations Economic Commission for Africa et al., 2017). They can also be explained in terms of non-tariff measures that act as non-tariff barriers. Non-tariff measures refer to regulations officially issued by a country that may affect trade, even in cases where the main objective is not to regulate trade but, for example, to ensure safety and quality. Non-tariff barriers are cost-increasing obstacles to trade and should be removed to enhance trade and integration. Not all non-tariff measures are non-tariff barriers, and vice versa. Rules of origin fall within the category of non-tariff measures. According to Brenton (2011), complex rules of origin can be a significant constraint on trade, a substantial burden on customs and a hindrance to trade facilitation, while the nature of the rules of origin can undermine the stated intentions of preferential trade agreements. Many of these obstacles are the results of policies that can be altered. Each category of obstacles is discussed in turn in this section.

Weak productive capacities

Addressing supply-side constraints and weak productive capacities is a policy imperative in Africa to boost intraregional trade through the development of regional value chains.

Such chains can be a critical vehicle for spreading the economic benefits of African trade (e.g. jobs in the formal sector and gains from manufacturing) to a wider set of countries, if they participate in such value chains and gain opportunities to upgrade technologically and move up within the value chains. The potential for converting primary commodities in Africa, including agricultural materials, into industrially processed finished products within regional value chains remains largely untapped. The Action Plan for Boosting Intra-African Trade of the African Union includes a productive capacities cluster with the objective of creating "regional and continental value chains/complementarity, to increase local production/trade in goods produced in Africa" (African Union, 2013).

Intra-regional economic community tariffs
2014–2016 average



Tariff-related trade costs

Advances in trade liberalization are being made across all regional economic communities (United Nations Economic Commission for Africa et al., 2017). However, the liberalization of tariffs within communities has been slower than scheduled, due in part to human and institutional capacity constraints in trade policy implementation, and also to a lack of operationalization of regional economic community agreements. According to the Abuja treaty, all regional economic communities should have established a common external tariff within customs unions and fully functional free trade agreements by end-2017. This has not yet occurred. For example, among all communities, ECCAS has the lowest share of intraregional trade in its total trade in Africa and would need to reduce on average 66 per cent of its tariff lines on intra-ECCAS tariffs to zero. In the other communities, the proportion of tariff lines on intraregional tariffs that have yet to be reduced to zero are 90 per cent in ECOWAS, 85 per cent in SADC, 78 per cent in IGAD, 51 per cent in AMU, 45 per cent in COMESA and zero in EAC, which has the highest share of intraregional trade in total trade in Africa among all communities. On average, applied tariff rates to intra-regional economic community members amount to 7.4 per cent in CEN–SAD, 5.6 per cent in ECOWAS, 3.8 per cent in SADC, 2.6 per cent in AMU, 1.89 per cent in COMESA, 1.86 per cent in ECCAS, 1.80 per cent in IGAD and zero in EAC (United Nations Economic Commission for Africa et al., 2016). However, reducing tariffs among regional economic community members or among countries in Africa will not automatically result in increased intra-regional economic community and intra-African trade. Some member countries, as exporters, may not fully utilize the preferential tariff lines under which tariffs have been reduced, because their export supply capacities in these lines are weak; their preferential tariff margin for exports is nullified by high non-tariff trade costs, making production and trade under these lines unattractive; or the costs of compliance with the rules of origin associated with these lines are too high.

Non-tariff barriers

There is a growing literature on the positive effects that trade facilitation reforms can have on intraregional and global trade due to the impact on reducing trade transaction costs (Organization for Economic Cooperation and Development, 2005; United Nations Economic Commission for Africa, 2018; United Nations Economic Commission for Africa et al., 2017; WTO, 2015). According to WTO, trade costs in developing countries can be equivalent to applying a 219 per cent ad valorem tariff on international trade and, even in high-income countries, the same product could face an ad valorem equivalent of 134 per cent in trade costs (WTO, 2015). It is estimated that full implementation of the Agreement on Trade Facilitation could reduce trade costs globally by between 9.6 and 23.1 per cent, with the highest average reduction in trade costs in countries in Africa and LDCs, in excess of 16 per cent (WTO, 2015). Broadly defined, trade facilitation reforms should encompass policies to reduce trade transaction costs that result from customs administrations, documentary requirements and border procedures, as well as policies for creating an enabling environment for trade that include behind-the-border policy reforms, improvements in transport infrastructure (roads, rails, ports, airports, etc.) and reduced bureaucracy and corruption (United Nations Economic Commission for Africa et al., 2017).

Non-tariff barriers can act as a significant hindrance to international and regional trade and offset expected gains from tariff reductions to firms. For example, while the average applied rate of tariff protection in Africa is 8.7 per cent, other obstacles have been found to increase the cost of African trade by an estimated 283 per cent (Sommer et al., 2017). Non-tariff barriers raise trade and transaction costs for businesses. Countries in Africa face large trade costs, associated with their hard and soft infrastructure deficits (in energy, transport, information and communications technology, logistics performance, etc.), complex customs and administrative procedures and other obstacles to moving goods across borders and delivering them to the final point of sale. Several studies have estimated the impact of trade facilitation reforms on international trade and trade in Africa and found positive results. For example, Portugal-Pérez and Wilson (2012) show that trade facilitation reforms improve the export performance of developing countries, in particular when they target investment in physical infrastructure and regulatory reform to improve the business environment. Freund and Rocha (2011) examine the effects of transit, documentation and ports and customs delays on exports from Africa and find that transit delays have the most economically and statistically significant effect on exports. For example, UNCTAD has noted the additional costs that poor transport and transit facilitation impose on the competitiveness of exports from Ethiopia; the labour costs of making a T-shirt in Ethiopia are one third of the costs in China, yet the logistics expenses of exporting the shirt mean that, in international markets, a shirt made in Ethiopia sells for the same price as a shirt made in China (UNCTAD, 2018e).

Calculations by the Economic Commission for Africa, based on a computable general equilibrium model, indicate that under the African Continental Free Trade Area, intra-African trade could increase from 10.2 per cent in 2010 to 15.5 per cent in 2022 but, if matched by improved trade facilitation and tariff reductions, such trade could more than double in the same period, to 21.9 per cent (United Nations Economic Commission for Africa, 2015; Mevel and Karingi, 2012). The Agreement Establishing the African Continental Free Trade Area, in annex 5 of the protocol on trade in goods, presents a general categorization of sources of non-tariff barriers (not all of which should be systematically removed) as follows: Government participation in trade and restrictive practices tolerated by Governments; customs and administrative entry procedures; technical barriers to trade; sanitary and phytosanitary measures; specific limitations; and charges on imports. Rules of origin are treated separately in annex 2. Annex 5 provides for a mechanism for the identification, categorization and progressive elimination of non-tariff barriers within the African Continental Free Trade Area and institutional structures for the elimination of non-tariff barriers, reporting and monitoring tools and the facilitation of resolution of identified non-tariff barriers.

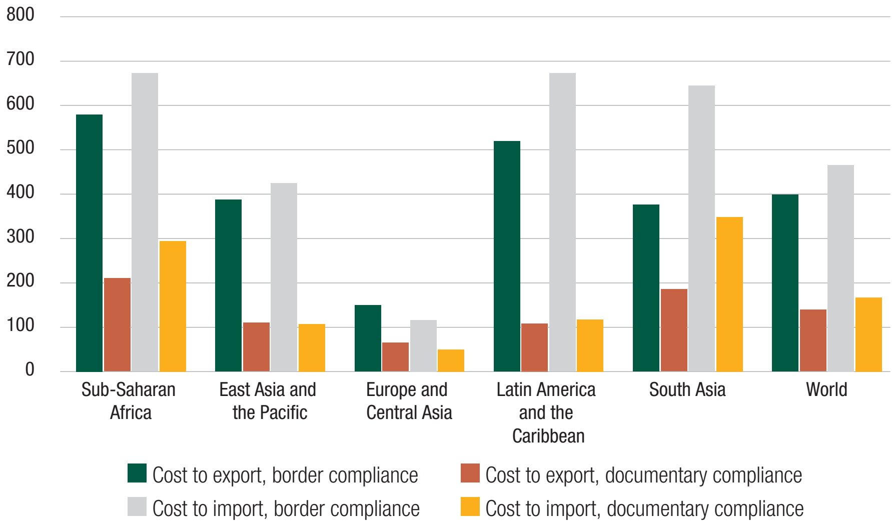
Countries in Africa tend to perform less well with regard to most indicators of trade facilitation relative to other regions. A comparison of sub-Saharan Africa with other regions and the world with regard to selected trade facilitation indicators is shown in figure 6. Sub-Saharan Africa has the highest cost to export compared with all other regions, as well as the highest cost to import, except for Latin America and the Caribbean, based on border compliance, and South Asia, based on documentary compliance.

Comprehensive and reliable data on non-tariff measures in Africa and their conversion to ad valorem equivalents is ongoing, yet some estimates are available and show that rates that can be as high as 14 per cent for vegetables, 11.4 per cent for beverages and tobacco, 11.3 per cent for machinery and 11.1 per cent for optical and medical devices (figure 7). Further, the impacts on trade, output, employment and income of reducing non-tariff measures are found to be positive in all countries in SADC and, depending on the initial trade flows and the magnitude and scope for removing the trade distorting effects of non-tariff measures, national exports can increase by up to 2.2 per cent (UNCTAD, 2016a). Efforts to enhance the regulatory convergence of trade regulations or the elimination of non-tariff measures need to be in parallel with the process of liberalizing market access conditions in the African Continental Free Trade Area. For example, UNCTAD has worked with several regional economic communities on non-tariff measures and non-tariff barriers and on developing systems to identify and remove non-tariff barriers and to promote mutual recognition or convergence (UNCTAD, 2016c).

Figure 6

Cost to import and export: Selected trade facilitation indicators by region, 2016

(Dollars)



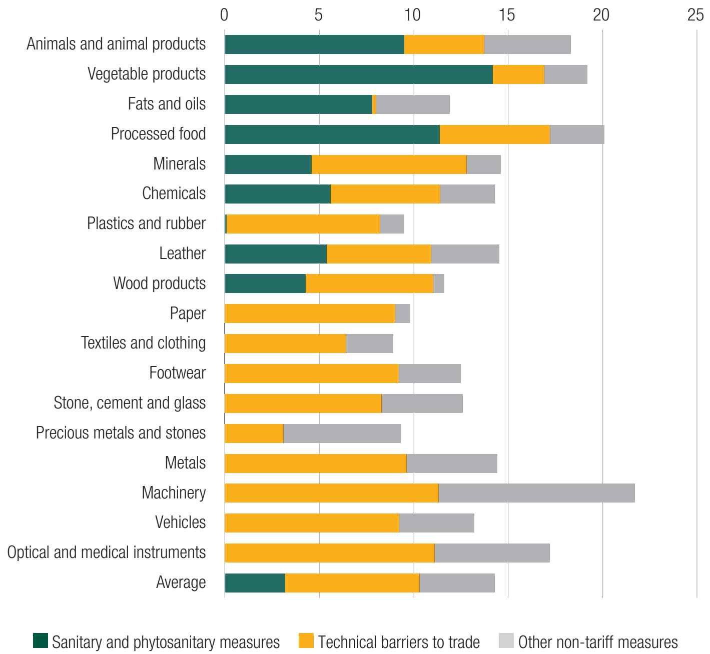
Source: UNCTAD calculations, based on the World Development Indicators Database of the World Bank.
Note: The data cover sub-Saharan Africa separately from North Africa as the latter is included in the Middle East. The cost measure is the fees levied on a 20-foot container in dollars. All fees associated with completing the procedures to import or export goods are included, including costs for documents, administrative fees for customs clearance and technical control, customs broker fees, terminal handling charges and inland transport costs. The cost measure does not include tariffs or trade taxes; only official costs are recorded.

Evidence based on surveys conducted by the International Trade Centre in 23 developing countries (13 in Africa) and LDCs in the period 2010–2013 indicates that for manufactured products, 35 per cent of the most difficult non-tariff measures applied by partner countries to manufacturing exports concern rules of origin and the related documentation. The stringency or complexity of rules of origin in industry appear much more difficult to comply with than rules of origin in agriculture (International Trade Centre, 2015). The most frequent complaints registered on the non-tariff barriers reporting, monitoring and eliminating mechanism of the Tripartite Free Trade Agreement relate to rules of origin (11 per cent of filed complaints).[10] For exporters, complying with rules of origin represents an additional cost to production, and for importers, enforcing compliance with rules of origin can exceed the capacities of weak customs administrations.

Figure 7

Ad valorem equivalents of non-tariff measures in Africa

(Percentage)



Source: UNCTAD, 2015a.

[10] See www.tradebarriers.org.

The establishment of online platforms through which businesses can register complaints about non-tariff barriers has been a welcome development among regional economic communities and in several countries in Africa, including Uganda, the United Republic of Tanzania and EAC. However, while mechanisms are in place to report non-tariff barriers, they may be ineffective or demanding, discouraging the reporting of non-tariff barriers by the private sector (Calabrese and Mendez-Parra, 2016).

Addressing the costliness to the private sector of complying with and enforcing the different types of rules of origin, as well as dealing with the consequences to intra-African trade of the non-recognition and non-application of rules of origin, should be at the core of the continent's agenda for eliminating the trade costs of non-tariff barriers, to ensure that the static and dynamic gains from the African Continental Free Trade Area are fully reaped. Such gains are discussed in section 1.4.

1.4 Potential gains for Africa from the African Continental Free Trade Area

The African Continental Free Trade Area presents opportunities for Africa, yet the translation of such opportunities into tangible socioeconomic benefits is contingent on the containment of a set of risks and on addressing implementation challenges (see chapter 4).

Traditional trade theory posits that free trade areas lead to both trade creation and trade diversion, with the former often outweighing the latter and generating, overall, a net positive effect on economic welfare (Viner's theory). Trade creation refers to increased levels of trade coming from members of a free trade agreement area due to the removal of tariff and non-tariff barriers and to better exploitation of comparative advantages, economies of scale and productivity enhancing resource allocation. This increases economic welfare if a trade partner is the low-cost provider in the first instance under the most-favoured nation clause. Trade diversion occurs when trade is diverted from more efficient third-party suppliers to the benefit of higher-cost producers under the free trade agreement, leading to reductions in economic welfare. However, trade diversion is not always welfare-reducing, for example, if there is a sudden cessation of imports from third parties. Simulations by Mevel and Karingi (2012) show that the removal of tariffs, supplemented by trade facilitation in the African Continental Free Trade Area, could lead to trade creation effects that are stronger than trade diversion effects, with intra-African trade estimated to increase by 52.3 per cent or $34.6 billion in 2022, compared with a baseline scenario of not having a free trade area. The simulations also indicate that the real wages of unskilled workers may rise, accompanied by a slight shift in employment from the non-industrial to the industrial sector (Mevel and Karingi, 2012).

There are also static and dynamic gains to the preferential trade liberalization underpinning the African Continental Free Trade Area. Static gains arise from short-term increases in economic welfare, and dynamic gains arise from competitive pressures that lead to long-term productivity gains. Competitive pressures provide incentives to producers to improve on their offers through innovation and technological upgrading and to build dynamic comparative advantages to perform better than the competition. The African Continental Free Trade Area, through preferential trade liberalization, could generate long-term increases in consumer and economic welfare through increased competition and faster innovation.

There will be short-term adjustment costs in the African Continental Free Trade Area, as labour, capital and resources are reallocated across sectors, yet most studies concur that the long-term benefits will outweigh such costs (UNCTAD, 2018f). Short-term adjustment costs include temporary job losses among groups in the labour force that will need to redeploy from shrinking economic sectors towards expanding sectors, in addition to lost tariff revenues for Governments, requiring more domestic resources. Long-term economic benefits will arise from unleashing the potential of regional value chains to foster industrialization, promote technological sophistication, boost economic growth and create decent jobs in the formal sector.

Some examples of potential gains from the opportunities presented by the African Continental Free Trade Area are discussed in this section.

1.4.1 Increased competitiveness of firms in Africa and boosting of intra-African trade and investment

The African Continental Free Trade Area is expected to provide momentum towards the consolidation of regional economic communities and the Tripartite Free Trade Agreement, with more communities having to align themselves to the provisions and obligations in the Agreement Establishing the African Continental Free Trade Area. Under the assumption that tariffs and non-tariff barriers will be reduced more quickly for members of regional economic communities and members in Africa, compared with non-members, such tariff and non-tariff barrier reductions should benefit intra-African trade by giving companies in Africa a boost to their competitiveness. New markets in

Africa will be created for African firms, as long as, inter alia, they are able to benefit from preferential trade margins compared with foreign competitors, highlighting the crucial role of the enforcement of rules of origin in this regard; the objectives in article 4 of the Agreement, including those on trade facilitation measures, are met; and the Action Plan for Boosting Intra-African Trade of the African Union is effectively implemented. Increased intra-African trade in the short-term can have a positive effect on intra-African investment in a range of areas, from infrastructure and services to technology. As the gains from the African Continental Free Trade Area become more visible and tangible to economic operators and the perceptions of long-term benefits improve, the incentives to invest in regional economic communities and on the continent strengthen, leading to a mutually reinforcing relationship involving higher levels of trade and investment, coupled with positive spillover effects on innovation and firm and industry-level productivity.

1.4.2 Improved business and investment climate that attracts foreign direct investment and fosters linkages between foreign and local firms

The implementation of article 15 of the Agreement Establishing the African Continental Free Trade Area and annex 4 on trade facilitation can lead to significant reductions in the indirect and invisible costs (World Economic Forum et al., 2009) of doing business in Africa. As tariffs and non-tariff barriers decline on the continent, there will be increased competitive pressures on firms in Africa to compete in non-price dimensions such as quality and differentiated marketing strategies based on branding that may involve, for example, the use of geographical indicators of origin and voluntary sustainability standards. The private sector may make a greater demand on Governments to improve on the investment climate and for States to scale up support to national entrepreneurial systems. Improvements in the business and investment climate, matched by stronger State support for entrepreneurs, could attract a larger volume of foreign direct investment and offer opportunities to local firms to engage in equity and non-equity forms of investment with foreign firms. The enforcement of article 4 of annex 4, requesting parties to promptly publish trade facilitation information on the Internet in a non-discriminatory and easily accessible manner, and other articles of the Agreement that emphasize the disclosure of information and transparency in guiding business transactions, can reduce sources of uncertainty and concern for both domestic and foreign investors. This can provide incentives for higher levels of domestic and foreign investment.

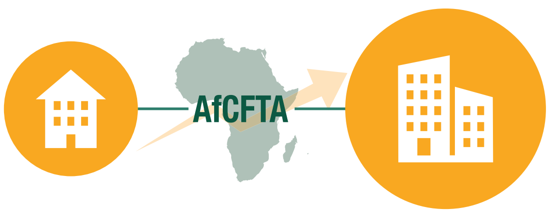
1.4.3 Economic growth and structural transformation

Regional integration can serve as a launch pad for building industrial capabilities in Africa and intensifying African trade in manufactured goods. The advent of digitalization and electronic commerce and the future potential application of additive technologies such as three-dimensional printing could transform the manufacturing and entrepreneurial landscape in Africa, generating opportunities for the customized mass-production of a range of consumer and intermediate goods by firms in Africa (Bolaky, 2019). If regional economic communities implement regional industrial policies and individual countries implement national industrial policies, supported by the implementation of the Accelerated Industrial Development for Africa initiative by the African Union, the African Continental Free Trade Area has the potential to act as a catalyst for manufacturing and industrial development in Africa and to drive inclusive structural transformation. Africa currently has the youngest population in the world. Harnessing this demographic dividend necessitates employment and entrepreneurship strategies, underpinned by structural transformation and the creation of marketable opportunities, which the African Continental Free Trade Area can provide.

1.4.4 Participation of small and medium-sized enterprises in regional and global value chains

If the African Continental Free Trade Area acts as a catalyst for industrialization on the continent and supports the development of regional value chains in manufacturing and agro-industry, gains can accrue to the private sector in Africa, as it taps into investment and commercial opportunities in these sectors. The development of regional value chains can also stimulate local entrepreneurship. Gains can accrue to SMEs in Africa, provided their insertion into regional value chains is facilitated by targeted public policies within SME development strategies (UNCTAD, 2018c).

African Continental Free Trade Area **creates new and larger markets for SMEs to grow**



Many SMEs in Africa have low chances of survival and expansion due to a range of constraints that affect their profitability (International Trade Centre, 2017; UNCTAD, 2018c). In the African Continental Free Trade Area, the creation of new and larger markets, matched by possibilities to produce at a larger scale behind preferential walls and engage in learning by exporting, can raise the odds of survival and expansion for SMEs, first in regional markets, then in global markets. There is empirical evidence in favour of the view that regional integration agreements raise survival rates and the performance of firms in export markets (Fugazza and McLaren, 2014; Kamuganga, 2012; Türkcan K and Saygılı, 2018). Participation in regional value chains can be a stepping stone for SMEs in Africa to enter global value chains once they have built a requisite level of competitiveness and possibly begun to operate as fully fledged stand-alone companies trading directly with a regional and international customer base. Electronic commerce can provide an additional development opportunity for SMEs in Africa, if countries in Africa improve their electronic readiness. The inclusion of negotiations on electronic commerce within the context of the African Continental Free Trade Area could support countries in Africa in engaging in strategic and forward-looking planning and policies to harness digitalization for augmenting the potential gains of the African Continental Free Trade Area and creating opportunities for SMEs in Africa.

1.4.5 Development of agriculture and agribusiness and implications for rural development

The potential for boosting intra-African trade in agriculture is substantial (UNCTAD, 2013). Intra-African trade in agriculture was 22 per cent in 2017, compared with 52 per cent in manufacturing, and down from 24 per cent in 1995.[11] In addition, the range of agricultural goods exported by Africa to the rest of the region or outside the region is narrow (figure 8). In 2014, in the Malabo Declaration on Accelerated Agricultural Growth and Transformation for Shared Prosperity and Improved Livelihoods, the African Union committed to, by 2025, tripling intra-African trade in agricultural commodities and services through, among others, the fast-tracking of the establishment of the African Continental Free Trade Area and the transition to a continental common external tariff scheme (African Union, 2014).[12]

There are many challenges to agricultural and rural development in Africa. Operationalization of the Agreement Establishing the African Continental Free Trade Area, along with its annexes on investment, trade facilitation, services, technical barriers to trade, sanitary and phytosanitary measures and rules of origin, can contribute to agricultural development in the following four major ways: by creating larger markets for small farmers through the removal of tariffs and non-tariff barriers; by bringing farmers to markets through improved trade facilitation and trade connectivity (e.g. better roads, faster transport and thinner borders); by attracting domestic and foreign investment

[11] UNCTAD calculations, based on the UNCTADstat database.
[12] See also www.fao.org/food-loss-reduction/news/detail/en/c/250883/.

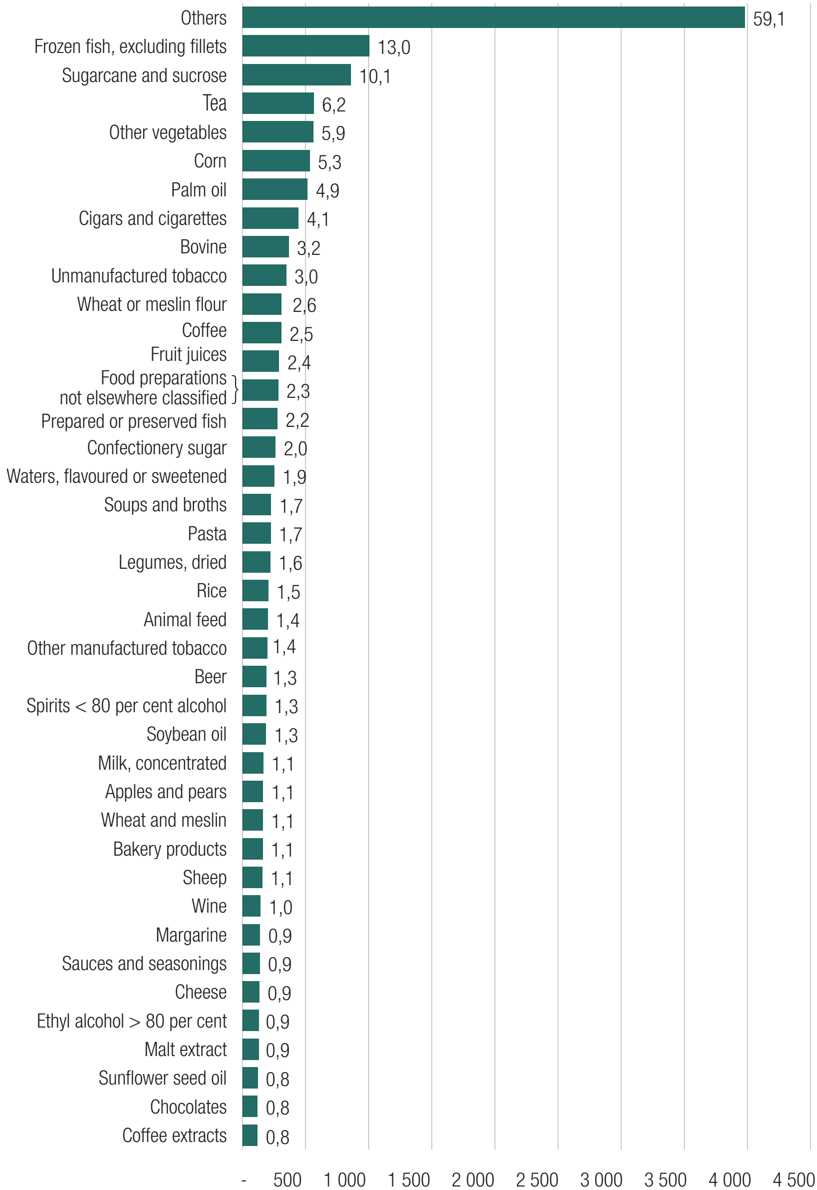
to the sector that can provide the necessary hard infrastructure (such as rural energy, rural water, cold storage facilities and warehousing); and by allowing the exploitation of opportunities in agribusiness and agro-industry linked to developing national and regional agricultural value chains whose end products are exported regionally and globally (see chapter 3).

Implementing the goals in the Malabo Declaration, such as allocating in national budgets at least 10 per cent of public expenditures annually to agriculture, and translating the African Agribusiness and Agro-industry Development Initiative into action will be important complementary measures to harnessing the African Continental Free Trade Area as a driver of agricultural transformation for the continent.

Figure 8

Top 40 intra-African agricultural-exports, 2014–2016

(Millions of dollars and percentage)



Source: UNCTAD calculations, based on Harvard University, 2018.

1.4.6 Unleashed potential of the services sector

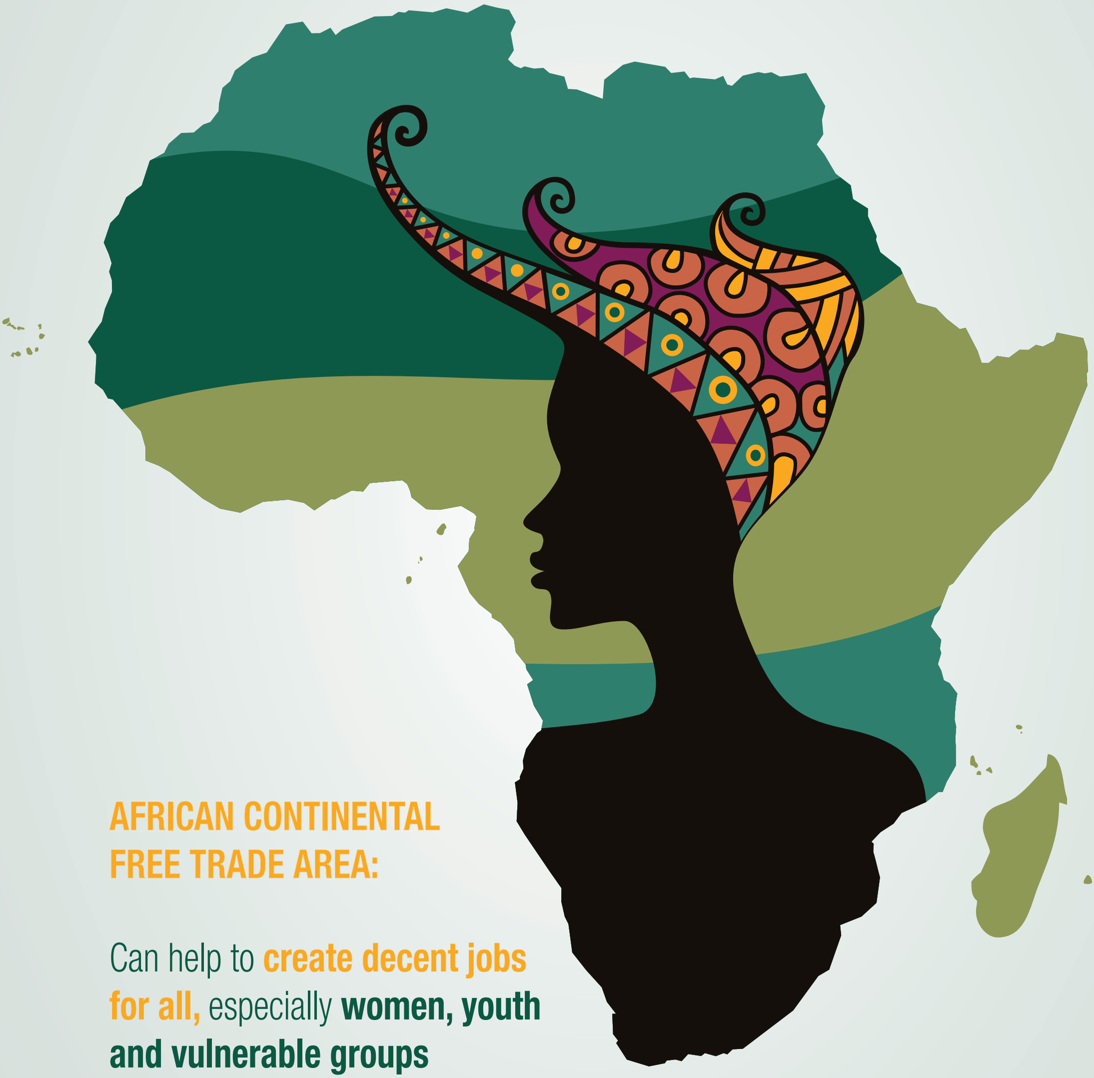
The services sector has a critical role to play in the structural transformation of the region, as a high value added standalone sector of its own (including in information and communications technology, energy, financial services and tourism) or as an intermediate sector facilitating the transformations of the industrial and agriculture sectors in Africa.

Intra-African trade in services is estimated to be low, and the services sector in Africa tends to be dominated by low value added and informal transactions, and does not exhibit or encompass sufficient levels of competitiveness, sophistication and efficiency to act as a backbone of economic activity for industry and agriculture, with the exception of a few subsectors in a few countries (International Trade Centre, 2017; UNCTAD, 2015b). Services should be the oil that greases the wheels of economies during transformative growth when it comes to facilitating transport and transit, providing efficient and rapid logistics, supplying reliable and affordable infrastructure services in energy, water and telecommunications and easing access to credit and finance for enterprises (UNCTAD, 2015b). The creation of a continental market could provide to services suppliers the scale of operations and the long-term finance they need to boost competitiveness in services provision and, in turn, contribute to improving trade facilitation on the continent and strengthening the gains from the African Continental Free Trade Area stemming from increased trade in goods.

1.4.7 Informal cross-border trade, gender implications and reduced illicit trade

Informality in economic transactions is prevalent in Africa. Informal trade is estimated to account for up to 30 to 40 per cent of regional trade in Africa. Informal cross-border trade in Africa can contribute up to 43 per cent of incomes in the region according to some estimates, and much of this involves women trading on a small scale, with the long-term impact on developmental outcomes unclear (Brenton and Soprano, 2018). A potential cost of informality lies in the fact that it undermines the effective operationalization of public and trade policies and the delivery of their goals, since economic agents operate outside of formal structures. Informal businesses and informal cross-border trade prevail for a range of reasons, including the lack of job and trade-related opportunities in the formal sector, as well as the prohibitive costs of operating in the formal sector.

The deepening of regional integration, to the extent that it can gradually provide more opportunities in the formal sector, in terms of jobs, entrepreneurship and trade, by accelerating transformative growth and the development of supply chains in several sectors, can contribute to the gradual reduction of vulnerability in employment, including



AFRICAN CONTINENTAL FREE TRADE AREA:

Can help to **create decent jobs for all,** especially **women, youth and vulnerable groups** among women and youth and, in the medium term, reduce the incentives to engage in informal trade and informal business transactions. Supporting informal traders in formalizing their trade matters for regional integration in Africa, as such a transition provides Governments with much needed tax revenues that can be used to finance regional integration programmes and compensate for lost tariff revenues under tariff liberalization.

Besides affecting domestic resource mobilization, regional integration can also have an impact on the levels of illicit trade and illicit financial flows in Africa. As regional integration accelerates and increases the returns on investment in licit activities in formal sectors, in which investors can have access to a range of tax breaks, State support and recourse to the judicial system in the event of disputes, the incentives to engage in unlawful activities are reduced. In other words, regional integration, by generating benefits and by opening up investment and trade opportunities, increases the returns to investors in retaining and reinvesting their profits in Africa.

1.4.8 Political stability and peace that can strengthen economic gains

Regional integration and regional trade tend to provide member countries with a common vision and set them on a common journey, whereby their economic interests are intertwined and contribute to the maintenance of regional peace and stability. By increasing the dependence of members on each other for trade and economic development, regional integration increases the cost of conflicts for member countries. Economic and political forces have the potential to become complements rather than substitutes, although the mechanisms underpinning this are often subtle.

Many factors can affect the degree and rate of implementation of the Agreement Establishing the African Continental Free Trade Area, including political economy factors that will impinge on the distribution of costs and benefits across countries, sectors and economic actors; success rates in implementing the complementary measures and initiatives that should underpin the African Continental Free Trade Area; global economic conditions; third-party arrangements entered into by countries in Africa such as the economic partnership agreements; the interface between regional economic communities and the African Continental Free Trade Area; and the sequencing, coherence and timing of areas of negotiation among regional economic communities and the African Continental Free Trade Area.

1.5 Why do rules of origin matter for the African Continental Free Trade Area?

Whether countries and firms in Africa decide to utilize the preferential tariff and non-tariff preferences to which they are entitled in the African Continental Free Trade Area depends on the expected costs and benefits of doing so, and rules of origin are a critical determinant of these costs and benefits.

If rules of origin in the African Continental Free Trade Area are too costly to be implemented by firms in Africa relative to the expected benefits or to the expected net benefits under third-party arrangements, firms will find it optimal to forgo utilizing preferences in the African Continental Free Trade Area. No matter how low preferential tariffs may be for firms in Africa under the Agreement compared with under other arrangements, the gains associated from such trade liberalization will be null and void unless the preferences are utilized. Rules of origin have a direct impact on the uptake of preferences and the rate of preference utilization.

Rules of origin in the African Continental Free Trade Area must be designed such that a sufficiently large number of firms in Africa utilize the tariff and non-tariff preferences to enter and participate in regional value chains and become active actors in the industrialization process in Africa. In addition, rules of origin perform the same role as local content requirements in the production of final goods and directly affect the range of local intermediate goods that are necessary to finalize the production of a given good. The wider the range of intermediate goods to be sourced from within Africa, the wider the possibilities for more firms in Africa to participate as suppliers and for countries in Africa to engage in manufacturing, technological upgrading and economic and export diversification and the larger, in principle, the expected gains to beneficiaries in Africa. However, locally made intermediate goods need to be as cost competitive as those that can be sourced from outside the African Continental Free Trade Area. Therefore, there is a need for complementary measures to improve on the business environment in Africa and accelerate business and trade facilitation reforms. For example, evidence from the implementation of the North American Free Trade Agreement shows that rules of origin contributed to lowering the amount of imports of intermediate goods from third parties (Conconi et al., 2018).

The nature of rules of origin, that is, how they are designed and their requirements and procedures, and the associated compliance costs, affect export performances and more. Depending on how rules of origin are specified, they can, “to varying degrees, restrict trade, misdirect investment, inhibit productivity growth and reduce welfare from levels otherwise attainable" (Gretton and Gali, 2005). Research comparing the different effects of different types of rules of origin shows that differences in product-specific rules of origin affect increases in export volumes (see chapter 3). For example, the more flexible rules of origin under the African Growth and Opportunity Act of the United States (requiring single transformation) have been found to stimulate exports from LDCs in Africa more so than do the restrictive rules of origin under the Everything but Arms initiative of the European Union (requiring double transformation) (De Melo and Portugal-Pérez, 2013; De Melo and Tsikata, 2015). Based on a gravity model for 155 countries and about 100 preferential trade agreements, Estevadeordal and Suominen (2005) find evidence that preferential trade agreements that have restrictive rules of origin tend to depress aggregate trade flows; regime-wide rules of origin that allow for flexibility in the application of product-specific rules of origin facilitate trade; restrictive rules of origin in final goods encourage trade in intermediate goods; and the negative effects of stringent product-specific rules of origin dissipate over time.

Making rules of origin too restrictive or administratively complex for eligibility for a trade preference increases compliance costs, even more so if domestic supplies are not as cost competitive as supplies from outside a free trade area. In extreme cases, firms may prefer to eschew preferential trade agreements altogether and trade on a most-favoured nation basis. If rules of origin are too flexible, the benefits decline in terms of domestic value added creation and domestic participation in regional value chains. There is a trade-off between increasing benefits to a region, in terms of stimulating regional production and trade by applying more stringent domestic requirements in rules of origin; and increasing costs, through the potential misallocation of resources by deviating sourcing from less expensive suppliers outside a free trade area. If rules of origin are too strict, the benefits to regional producers of lower tariffs may be offset by the higher costs of meeting rules of origin requirements. In addition, complex and stringent rules of origin require capable customs officials and administrative systems that can enforce them. Finally, countries in Africa suffer from a missing middle problem, meaning that a high number of SMEs coexist with a few large and more productive firms (UNCTAD, 2018c), and the costs for SMEs of compliance with rules of origin requirements must be given due attention when framing policies on developing regional value chains in Africa.

Rules of origin negotiations have at times involved a clash between two contrasting and at times dogmatic views. On the one hand, some economists argue that rules of origin should not be used as a protectionist or industrial policy tool, altered to support the development of linkages between upstream and downstream producers. They should be confined to the simple role of authenticating the origin of goods and not be ascribed a developmental role, as this undermines overall efficiency and distorts trade. This approach largely neglects the dynamic effects that rules of origin may have on the emergence of new productive activities and more integrated regional production networks. On the other hand, rules of origin negotiations have often departed from orthodox economic stances, showing the lack of progress in rules of origin convergence, and typically been inundated by lobbying and protectionist pressures. In this context, the risk of regulatory capture is exacerbated by the increasingly technical and often opaque nature of rules of origin negotiations, as well as by well-known asymmetric information problems, with results that might derail well-intentioned efforts to deepen regional integration and enhance the development of productive capacities.

In departing from both of these extreme views, this report argues that the best way to approach this dilemma is to leverage the African Continental Free Trade Area as an opportunity to enhance the consistency of trade policy with industrial policy objectives and the continent's transformation agenda. With regard to rules of origin, as with other elements of the negotiations with regard to the African Continental Free Trade Area, dynamic processes of learning by doing and the progressive acquisition of technological capabilities, political economy factors and distributional concerns all matter in ensuring long-term economic viability. In this regard, rules of origin can have a functional role to play in stimulating and shaping the development of regional value chains in Africa; static economic efficiency is not enough. However, rules of origin are not an industrial policy tool, and should not be crafted as such, nor should they be used as a protectionist tool to build non-tariff barriers around regional suppliers.

A key question concerns how restrictive and stringent or how flexible rules of origin should be, and the answer must come from an in-depth knowledge of sectoral dynamics, a thorough understanding of the African Continental Free Trade Area process and a strategic assessment of the positioning of the free trade area in the context of the developmental and industrialization strategy of Africa.

Rules of origin must be flexible enough, especially at the beginning, to allow countries in Africa with weak supply capacities to take up trade preferences, benefit from trade liberalization and start building capabilities and competitiveness in domestic production, to participate in regional value chains. Rules of origin may become gradually more restrictive and stringent, increasing the content requirements for domestic processing, as the region continues to improve both productive capacities and competitiveness. Countries in Africa may pursue a gradual, incremental approach in terms of flexibilities for weaker economies, graduating towards increasing the stringency and complexity of rules of origin as regional value chain-based industrialization develops on the continent. Changes to the rules of origin regime should also be based on evidence gathered on the impact of rules of origin on industrial capabilities in Africa. This requires instituting a set of guiding principles or best practices to govern the design of rules of origin, developing indicators to measure the degree of restrictiveness or flexibility of rules of origin and establishing a monitoring and evaluation system to assess the effectiveness of the current rules of origin regime. The implication of rules of origin on the work of customs authorities who must verify and enforce them is critical and capacity-building programmes for customs authorities in Africa are needed, in addition to platforms that facilitate speedy, automatic and transparent exchanges of information among all customs authorities in Africa.

The African Continental Free Trade Area should adopt rules of origin that are simple (in the sense of being clear and understandable), transparent, predictable and trade-facilitating for businesses and trade operators, as well as stable in the short to medium terms yet evolutive in the longer term to allow for adjustments to changes in the business environment, while remaining context, industry and sector-specific, and aimed at making the best use of existing technologies (see chapters 2 and 4). Both the contents of rules of origin and their administration matter in determining the net benefits of compliance to parties. The framing of procedural requirements for complying with rules of origin should be given proper attention, in addition to design considerations, and should involve consultations with the private sector. For example, the International Convention on the Simplification and Harmonization of Customs Procedures, 1974, revised 1999 (Kyoto Convention) emphasizes the importance of the application of simple yet efficient procedures.

The building of a restrictiveness index on rules of origin for all regional economic communities in Africa and the African Continental Free Trade Area could help coordinate and ensure convergence among rules of origin requirements under the various regional integration arrangements on the continent, to ease the burden on customs and firms in Africa, with a view to boosting intra-African, intra-regional economic community and inter-regional economic community trade. These issues are further addressed in chapter 2.

1.6 Conclusion

The degree of complexity and restrictiveness in rules of origin should consider the levels of product diversification, sophistication and competitiveness in member countries; too restrictive and complex rules of origin at low levels of regional productive capacities can provide incentives to member countries to trade outside the African Continental Free Trade Area rather than within. Such incentives may be greater for small and/or low-income countries such as LDCs, in which productive capacities and competitiveness levels may be lower.

The nature of rules of origin, that is, how they are designed and their requirements and procedures, and the associated compliance costs affect export performances and more. Depending on how rules of origin are specified, they can, to varying degrees, restrict trade, misdirect investment, inhibit productivity growth and reduce welfare from levels otherwise attainable. However, rules of origin have a functional role to play in stimulating the development of regional value chains in Africa and the participation of downstream and upstream suppliers in Africa in regional value chains, to achieve the goals of the Abuja treaty.