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Transforming Africa's Trade

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The AfCFTA's Rules of Origin: Importance and Impact on the SME-Factoring Interface

Key Messages

- Rules of Origin (RoO) are important for protecting signatory countries to the AfCFTA against abuse by competitive third countries which can easily penetrate their vulnerable economies by taking advantage of preferences offered.
- RoO are “passports” which allow goods and services to circulate within the AfCFTA as long as such goods and services originate within and among the state parties of the AfCFTA.
- RoO must be sensitive to the strategic growth objectives of SMEs by enabling their participation in regional markets and value chains.
- The cotton, textile, and apparel industry provides an auspicious opportunity for accelerating SME growth and development in regional markets and value chains; as well as being a new frontier for the expansion of factoring as a practice, business, and industry.



Introduction

The African Continental Free Trade Area (AfCFTA) Agreement currently enters a critical phase of implementation and negotiation concerning its strategic modalities in liberalising trade in goods and services. As such, it will create a transformative integration environment which will have to be carefully and judiciously managed in terms of the imperatives and demands of the continental preferential market which the Agreement has inaugurated (UNECA 2017, Ismail 2021). This is a market of 1.4 billion people, a combined GDP of US\$3.4 trillion, and, very significantly, 55 economies at very different levels of development. Of these, 34 are categorised as Least Developed Countries (LDCs), 16 are Landlocked Least Developing Countries (LLDCs), and six are Small Island Developing States (SIDS).

This is why the Rules of Origin (RoO) become especially important to protect signatory countries of the AfCFTA against abuse by competitive third-countries that can easily manipulate such signatory countries—at very diverse stages of development—as entry points to penetrate the entire AfCFTA trading ecosystem, thus undermining the free flow of goods, services, capital, and labour. Therefore, the strategic purpose and normative logic of RoO are to determine the national origin of a product and crucially, to define basic formulae and thresholds for local content or beneficiated value-added before the product is re-exported (UNCTAD 2019).

Moreover, as the AfCFTA increasingly creates a new milieu of opportunities for the continent's 44 million SMEs, RoO will serve a transcendent purpose which moves beyond simply liberalising markets among signatory countries. They create incentives and encourage investment, especially in higher value-added manufacturing and services; they play a critical role in developing regional value chains; and they assist with increasing the flows of intra-regional trade. Thus, RoO in the AfCFTA serve a fundamental objective of being transformative instruments in driving economic integration of the continent based on the ethos and spirit of developmental regionalism (Gourdon et al., 2020).

Moreover, and if properly implemented and enforced, the rules could be catalysts for improving the levels of intra-African trade which currently is a mere 15 per cent compared to 47 per cent in the Americas, 61 per cent in Asia, and 67 per cent in Europe (UNECA 2021). The modalities of preferential trade liberalisation which RoO are aimed at determining could thereby boost intra-African trade by 33 per cent and create new market opportunities for SMEs in regional value chains.

The permissive and empowering potential of RoO for SME's growth and development will, however, come to nought unless their abiding financing constraints are addressed. This is where factoring will prove its worth by freeing up working capital for SMEs by enabling their participation in the flow of goods and services within supply chains; or put another way, especially in cross-border transactions where RoO become more significant in enhancing intra-African trade (UNCTAD 2019).

The Policy Brief intends to examine the essential parameters of the AfCFTA's RoO with a focus on how such rules could benefit SMEs, encourage the growth and development of the factoring industry, and thereby create synergistic linkages between them. In so doing, the analysis will explore trends in the cotton, textile, and clothing industry as a case study in which the SME-factoring interface could unlock bountiful mutual benefits in regional supply chains.



Understanding the AfCFTA Rules of Origin

The architectural contours and operational details of the AfCFTA's RoO are contained in Annex 2 and Appendix IV of its Protocol on Goods (AfCFTA 2022). It is noteworthy and of great significance that member states have reached agreement on RoO involving 87 per cent of tariff lines which comprise about 3800 of such lines (AUDA-NEPAD 2022). But what exactly does this mean? For purposes of explication, let us examine the essential features of the RoO.

Firstly, in metaphorical terms, they can be understood as a “passport” which allows goods and services to circulate duty free within the conceptual and geographic space of the AfCFTA, the *sine qua non* condition being that such goods and services must originate within the countries covered by the agreement. The RoO thus establish the necessary benchmarks and relevant criteria that must be met for products and services to be deemed as originating in an exporting country within the AfCFTA to qualify for preferential treatment, namely, to be eligible for zero import tariffs.



In short, RoO are aimed at clearly and precisely determining the origin of goods within the AfCFTA landscape (UNCTAD 2019, WCO 2023). In this regard, there are two very important requirements, namely, adhering to the principles of territoriality and direct transportation. Territoriality requires that the process of production or delivery of the service must be carried out uninterrupted within the AfCFTA. A product or service originates within the AfCFTA if it does not undergo further production or processing outside the AfCFTA geography of state parties and remains under customs control while outside the territories of the state parties (AfCFTA 2022, WCO 2023).

Direct transportation requires that a product or service that originates in the state parties will only receive preferential treatment at importation if it is transported directly between the territories of the state parties or through those territories. Importantly, transportation of originating products may occur through other state parties through transshipment or temporary storage in those territories, provided that the products remain under customs control and do not undergo any other operations unless for uploading, reloading, and preservation (AfCFTA 2022, WCO 2023).

Secondly, as a “passport” it is important to have a notional sense of the workings and basic *modus operandi* of RoO. The reciprocal spirit of preferential trade liberalisation under the AfCFTA requires that each participating member state grant each other trade preferences and as such, they would source greater volumes of intermediate and final goods as well as services from among themselves rather than importing these from third countries or from those abroad. By so doing, the AfCFTA RoO encourages and promotes dynamic forms of trade creation since, in theory, the most efficient producers would reduce the unit costs of production which in turn will lower prices and improve the quality of goods and services throughout the AfCFTA complex (Tralac 2021).

In addition, the integration agenda would be enhanced through spurring both domestic and regional value addition, thus creating a virtuous circle by reducing the continent's dependence on commodity extraction and generating more employment opportunities through SME empowerment, especially in harnessing the continent's demographic dividend (Drummond, Thakoor and Yu 2014; Asafu-Adjaye and Brown 2021).

Thirdly, there is an imperative for the RoO to be sensitive, on the one hand, to the strategic growth trajectory of SMEs, especially in promoting and enabling their participation in regional markets and value chains; and relatedly on the other, there must be a recognition of the critical role that factoring can play in facilitating the seamless flow of goods and services within and across supply chains that are open and receptive to SMEs. A major challenge in this regard is to ensure that RoO are not onerous and costly in their compliance standards and regimes when it comes to SMEs and factoring entities.

If the main origin criteria and regime wide RoO do not allow leniency, for example, on product specific rules or in specific sectors, there is a risk that SMEs and other businesses may opt out of the preferential platforms and decide to trade only in domestic economies or within regional markets by conducting transactions with their counterparts outside the remit of the AfCFTA. The result would be to stymie the incremental gains and comparative advantages that would flow from developing and consolidating regional value chains across the continent-wide preferential environment (Kaplinsky and Morris 2020).

This challenge, however, is not insurmountable since the general RoO provisions in Annex 2 are context specific and apply equally to all products, goods, and services specified in the tariff lines. These designations and attributes are important for two reasons: firstly, for purposes of crowding in SME participation and enabling the development of the factoring industry, the AfCFTA RoO are simple, transparent, business friendly, and predictable; and secondly, they do take account of the different productive capacity levels of member states as well as the structural asymmetries that affect countries which are LDCs, LLDCs, or SIDS and which face their own challenges in taking advantage of preferential tariff disciplines *and* implementing the RoO requirements (Tralac 2021).



SMEs, factoring, and the potential of the cotton, textile, and apparel industry

The AfCFTA represents a transformative moment in the continental landscape of historical attempts to put in place normative, strategic, and operational prescripts for integration that would be faithful to the vision of Pan-Africanism (Ismail 2021). This moment takes on greater significance because of the preferential margins which the AfCFTA RoO make possible among Africa's subregions, state parties, economies, and industries. The cotton, textile, and apparel industry provide an auspicious opportunity for accelerating SME growth in regional markets and value chains; as well as being a vector for the entry of factoring as a practice, business, and industry into the sector (Ismail 2022).

While China's market share has declined, it remains a dominant player as the largest exporter of apparel, with an export value of US\$150 billion, representing a third of the global export market (Whitfield et al., 2021). African countries only make up around 6 per cent of global lint output, 5 per cent of global cotton exports, and 2 per cent of global apparel exports while importing more than 70 per cent of its cotton fabrics (UNCTAD 2019). Moreover, growth and development of the sector has been seriously hampered and undermined by the global imports of second-hand clothing in Africa which accounts for almost a third of global imports with a value of US\$5 billion in 2019 (UNCTADStat, 2021).

For the “cotton four” of Benin, Burkina Faso, Chad, and Mali cotton is a critical export and source of local employment. However, the general characteristic of the sector is that African countries remain primary exporters of textiles and apparel to global markets with a very small share going to domestic and regional markets (Mold and Chekwoti 2021). Consequently, apparel production in Africa is integrated into global value chains which primarily supply branded products to consumers in developed countries. Multinational combines and lead companies—which own the brands' trademarks, names, logos, and symbols—typically dominate these global value chains; while African countries are supplied with intermediate inputs which are then processed under arrangements of cut, make, and trim which are low-value and labour-intensive assembly activities (UNCTAD 2019).

For purposes of growing and developing the SME-factoring interface in the industry, there are matters to be considered in the revitalisation of the cotton, textile, and apparel industry in Africa (Mold and Chekwoti 2021, Ismail 2022).

Firstly, the AfCFTA provides an exceptional opportunity to not only develop regional value chains with dynamic externalities through its RoO, but also for SMEs to participate in processing and manufacturing platforms through their involvement in particular and carefully identified parts of the regional value chains. This participation could be a stimulus for private equity and venture capital firms as well as other large investors to establish factoring and related services that are both capital- and labour-intensive. The utilitarian purpose must be to create vertical and horizontal integration opportunities for SMEs in textile, cotton, and garment production not only for an exclusive African market but also in global value chains that shape the apparel export industry.

Rather than being restricted to low-value segments in global value chains, this is a historic opportunity to use RoO policy instruments to transform the industry through localisation of the supply and production chains such that SMEs and factoring generate the necessary economies of scale through producing greater volumes of inputs across the value chain and stimulating the emergence of new local suppliers. Such localisation has the added advantage of not only providing more operational and production linkages to regional markets and global export networks, but also backward linkages into the local economy (Whitfield et al., 2021). This will create more employment especially for women and youth and attract more investment; but crucially, also generate factoring opportunities to deal with liquidity challenges and capital deficits that invariably will remain a binding constraint on SME's realising their potential in the industry.

Secondly, the structural pathology persists where the majority of African countries still depend on commodity trade for production, jobs, export revenue, and fiscal solvency; while asymmetric forms of external trade continue due to trade and aid reliance on developed countries, such that African countries are relegated to the status of a commoditised periphery (le Pere 2020). The passage of the AfCFTA and its RoO can inexorably change these dynamics through the development of regional value chains. For example, cotton from the “cotton four” in West Africa can be turned into textiles within the AfCFTA, thereby providing intermediate fabric for a garment industry that invites both SME involvement and factoring liquidity and capitalisation. This will open new avenues for productivity and employment in what could become increased value-added by virtue of growing intra-regional flows of trade in cotton, textiles, and apparel.

Through permissive RoO preferences uniquely tailored to African conditions for SMEs and factoring, regional economic hubs can be developed that form strategic bases for attracting investment and new technologically-driven processing and production methods which, in turn, are salutary for promoting backward and forward linkages that have positive spinoffs for cross-border trade and transactions.

Thirdly, in applying RoO to generate dynamic welfare and economic gains in the AfCFTA for the cotton, textile, and apparel sectors, there are different transformation thresholds to be considered. This is to ensure that the different sectors not only increase production and gain more market share in sub-regions and the continent as a whole, but also make the industry globally competitive through economies of scale and comparative advantage (Whitfield et al., 2021). The policy challenge is to incrementally develop value chains which are specifically geared towards greater SME participation and factoring growth based on the following transformation thresholds (Ismail 2022):

- **Single transformation:** this involves one production step in the AfCFTA for the product to meet originating status; namely, turning fabric into apparel.

- **Double transformation:** this involves two production steps in the AfCFTA for the product to meet originating status; namely, turning yarn into fabric, which then is turned into apparel.
- **Triple transformation:** this involves three production steps in the AfCFTA for the product to meet originating status; namely, turning cotton into yarn, which is then turned into fabric for the final step of producing apparel.

While these thresholds are conducive to and could become critical catalysts for developing regional value chains and enhancing intra-regional trade, the policy challenge underpinning them is to vastly improve the trading capacity, knowledge and information base, and business acumen of Africa's 44 million SMEs to participate meaningfully in this attractive sectoral ecosystem of boundless opportunity; and for factoring to gain serious traction as a financing mechanism for doing so. This relates particularly to developing the regional demand-side for factoring in a very narrow market where about 80 per cent of factoring business is conducted domestically and where single players like South Africa are dominant (Oramah 2014).

The AfCFTA certainly opens a pan-regional market for factoring as the value chain logic of the cotton, textile, and apparel industry suggests. However, shock absorbing capacity is required to mitigate risk and to manage the risk appetite that will invariably come with SME attempts to penetrate regional markets and participate in regional and global value chains. In this regard, the critical role of credit guarantee schemes, credit information services, regulatory regimes, and developing reinsurance capacity for regional trading cannot be stressed enough.

On the supply-side, a range of SME-related measures besides capital and financial liquidity will, therefore, have to be addressed. These include understanding the technical components of factoring, integrating digital technologies, shifting to green energy, attracting investment, improving administration and management systems, meeting regulatory standards, complying with domestic tax codes, navigating problematic non-tariff barriers, and so on.

Policy Considerations

The reflections in the Policy Brief elicit considerations in three dimensions:

- **The supply-side dimension:** While there is flexibility and a certain level of leniency in the AfCFTA's RoO, there is a need to better understand and take account of specific sectoral dynamics and product-specific inputs. These could either be wholly attained in terms of local content and extraction or could be subject to substantial transformation based on three methodological principles of: a) the percentage to determine the origin status; b) product lines that have been subject to specific processing conditions; and c) if there has been a change in tariff classification based on the use of non-originating materials. The ACBF, the AfCFTA secretariat, the AfDB's secretariat for Making Finance Work in Africa in close cooperation with UNECA and UNCTAD should conduct a study to determine which AfCFTA's RoO disciplines support the participation of SMEs in product specific sectors. This will add greater clarity and certainty to the potential of SME participation in the development of local supply chains, and entry into the extensive and diversified goods and services demanded in regional markets and value chains.
- **The value-chain dimension:** The general industry context shows that: the continent remains dependent on imported textiles, China remains the largest apparel exporter, and two-thirds of global apparel exports are destined for the US and EU consumer markets. The AfCFTA RoO, therefore, provide a major opportunity to develop Pan-African cotton, textiles, and apparel industries that are capable of spreading opportunities among Africa's SMEs across the three transformation levels referred to. The focus must be on SMEs located in Africa's LDCs, LLDCs, and SIDS with the end in view of not only building industries that are price competitive in state parties' domestic and regional markets, but are capable of becoming global "Made in Africa" brands. This will require significant development of local production capacity and supply chains, coherent sectoral strategies and industrial policies, large direct investments in physical and human capital, integrating technological processes, and making significant improvements in infrastructure. The ACBF, the Afreximbank, the Africa Finance Corporation, the AfCFTA's Guided Trade Initiative and its SME Facility, and the African Business Forum (representing the private sector) in conjunction with UNECA, the AfDB, and the IMF should constitute a task team to examine how RoO in the cotton, textiles, and apparel industries could assist SMEs to enter, sustain, develop, and benefit from their participation in regional value chains and what would be required in policy and practice to make this an operational reality.

- **The factoring dimension:** Globally and especially during the COVID-19 pandemic and its aftermath, factoring has become a critical source of external and credit financing for SMEs. In this regard and as a flexible financing solution, there are different factoring products that have been developed to support SMEs, especially those that involve trading and doing business with a large anchor buyer, otherwise known as reverse factoring. The great virtue of this mechanism is that the receivables purchased is determined by the creditworthiness of the anchor buyer which means that this form of factoring enables high-risk SMEs to transfer the credit risk to high-quality and trustworthy buyers. It is, therefore, the SME's client's ability to pay that reduces the lending risk and makes the accounts receivable a particularly attractive asset class. In the case of resuscitating Africa's cotton, textiles, and apparel industries, domestic and regional supply and value chains could be fuelled by receivables finance in trading transactions that are driven by reverse factoring. The ACBF, Afreximbank's Factoring Unit, the AfCFTA's Guided Trade Initiative and its SME Facility, the AfDB's secretariat for Making Finance Work in Africa, with the assistance of FCI and the Africa Finance Corporation should constitute a task force to:
 - * develop an inventory and data base of the current stakeholders in the cotton, textiles, and apparel industry across the eight regional economic communities who can be mobilised to take advantage of the preferential schemes offered in the RoO for the industry;
 - * explore modalities for foreign direct investment, local capital formation, and credit guarantee programmes that could form the basis for the emergence and establishment of a dedicated factoring and supply chain finance ecosystem in the industry. This could include private equity and venture capital firms, commercial banks, sovereign wealth funds, international financial institutions such as the IMF, World Bank, and AfDB, as well as regional development finance institutions; and
 - * develop capacity building and support systems for SMEs to enter the industry through business development and mentoring schemes; providing capital for improving the manufacturing, processing, and transport infrastructure; and introducing technological solutions such as distributed ledger technology (blockchain) and receivables platforms that allow SMEs to sell their receivables to a wider spectrum of investors.

Conclusion

The AfCFTA's RoO represent a paradigm shift in the trading environment of the continent. In design and implementation, the rules could provide greater momentum for realising the developmental ambitions of the Agreement, but also stimulate modes of transformative industrialisation by giving life to regional value and supply chains. The SME-factoring interface could play a major role in these regional dynamics by creating backward and forward linkages.

Such developmental and transformative potential already exists in Africa's cotton, textiles, and apparel industries which have experienced a marked decline, but can be revived through strategic and prudential use of RoO on one hand; and on the other, higher levels of value-added SME participation to become continentally productive and globally competitive.

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