THE TREATMENT OF GOODS ORIGINATING IN SPECIAL ECONOMIC ARRANGEMENTS / ZONES IN THE AFRICAN CONTINENTAL FREE TRADE AREA

Technical Paper

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SUMMARY

As part of the negotiations for the Africa Continental Free Trade Agreement (AfCFTA) AU Member States are considering how to treat goods produced from Special Economic Arrangements / Zones (SEZs) under the Rules of Origin. Two proposals have been tabled that goods coming from SEZs should not be considered as originating and therefore, not benefiting from preferential tariff treaties.

Rules of origin allow FTA members to determine source of origin of goods. This is usually done by using rules of origin to determine whether goods are wholly produced (which, geographically, would apply to goods coming from SEZs) or substantially transformed, either manufactured using a specified process; or through an ad valorem criteria; or a change of tariff classification criteria. Goods manufactured in SEZs should comply with the applicable origin criteria to be considered as originating and benefit from preferential tariff treatment.

The basic requirements for implementing a FTA are rules of origin and a tariff phase-down schedule. Rules of origin should only be used to reduce trade deflection while, at the same time, creating a conducive environment for trade in originating goods to take place between FTA members. Best practice suggests that rules of origin should not be used as a protectionist measure.

The concern of some African countries is how to address unfair competition that may emanate from goods produced in SEZs and trade under AfCFTA preferential treatment. The rationale is that, as goods produced in SEZs benefit from tax and other investment incentives, the cost of manufacture will be lowered so goods produced in SEZs will be able to be sold for less than goods not manufactured in SEZs. The challenge with this argument is:

- SEZs have evolved from firms in an enclave and many countries offer tax and investment incentives to companies / firms not in a specific enclave;
- Excluding goods produced in SEZs will reduce the effectiveness and efficiency of the AfCFTA; and
- The tax incentives provided to firms in SEZs may not allow them to reduce costs of production.

The preliminary findings of this paper suggest that using rules of origin as a means to avoid unfair competition, a use that rules of origin are not designed for, will be ineffective and counterproductive. Instead AfCFTA State Parties should make use of WTO rules on subsidies and countervailing measure as referred to in Article 2 of Annex 9 to the AfCFTA Protocol on Trade in Goods.

The WTO (which most AU Member States are either Members of or are in the process of acceding to) has an Agreement on Subsidies and Countervailing Measures (ASCM) containing the appropriate legal trade remedies to address any unfair advantage that may be conferred by subsidies in form of tax holidays, rebates and incentives to firms located in SEZs.

1. SPECIAL ECONOMIC ARRANGEMENTS / ZONES

“Export Processing Zones,” “Special Economic Zones,” “Free Trade Zones”, “Free Zones,” “Enterprise Zones,” and similar terms and phrases are used to describe geographically limited and specially administered areas within a country that are established to attract local and foreign direct investment (FDI), trade, employment and industrial development.

There is no single authoritative definition of “Special Processing Zones” or the various other terms used to describe SEZs but SEZs usually provide firms within the SEZs with preferences, which are granted by government such as preferential tax or duty treatment; exemptions from restrictions on the repatriation of profits; direct subsidies and enhanced physical infrastructure; and expedited permitting and related services.

There are a large variety of forms of SEZs ranging from zones in China, which may be entire provinces, to much smaller fenced-in economic zones. In effect, SEZs can provide a platform for developing the infrastructure and regulatory environment in a country that enables concentrated business activity to take place in a geographically limited area. However, it should also be noted that today’s SEZs have evolved from their original definition and many firms, called export processing firms, now benefit from the incentives offered in the zones without being physically fenced in. This makes the task of determining SEZs, and identifying firms that receive benefits usually associated with SEZs, more difficult.

As a World Bank publication[1] explains, an export processing zone is one of many export promotion tools, including bonded warehouses and temporary admission schemes that are geared to provide a country with foreign exchange earnings by promoting non-traditional exports; create jobs and generate income; and attract foreign direct investment, engendering technology transfer, knowledge spill-over, demonstration effects, and backward linkages.

SEZs generally share several common features:

- They allow duty-free imports of raw and intermediate inputs and capital goods for export production;
- Government red tape is streamlined, allowing “one-stop shopping” for permits, investment applications, and the like;
- Labour laws are often more flexible than for most firms in the domestic market;
- Firms are given generous, long-term tax concessions;
- Communications services and infrastructure are more advanced than in other parts of the country; and
- Utility and rental subsidies are common.

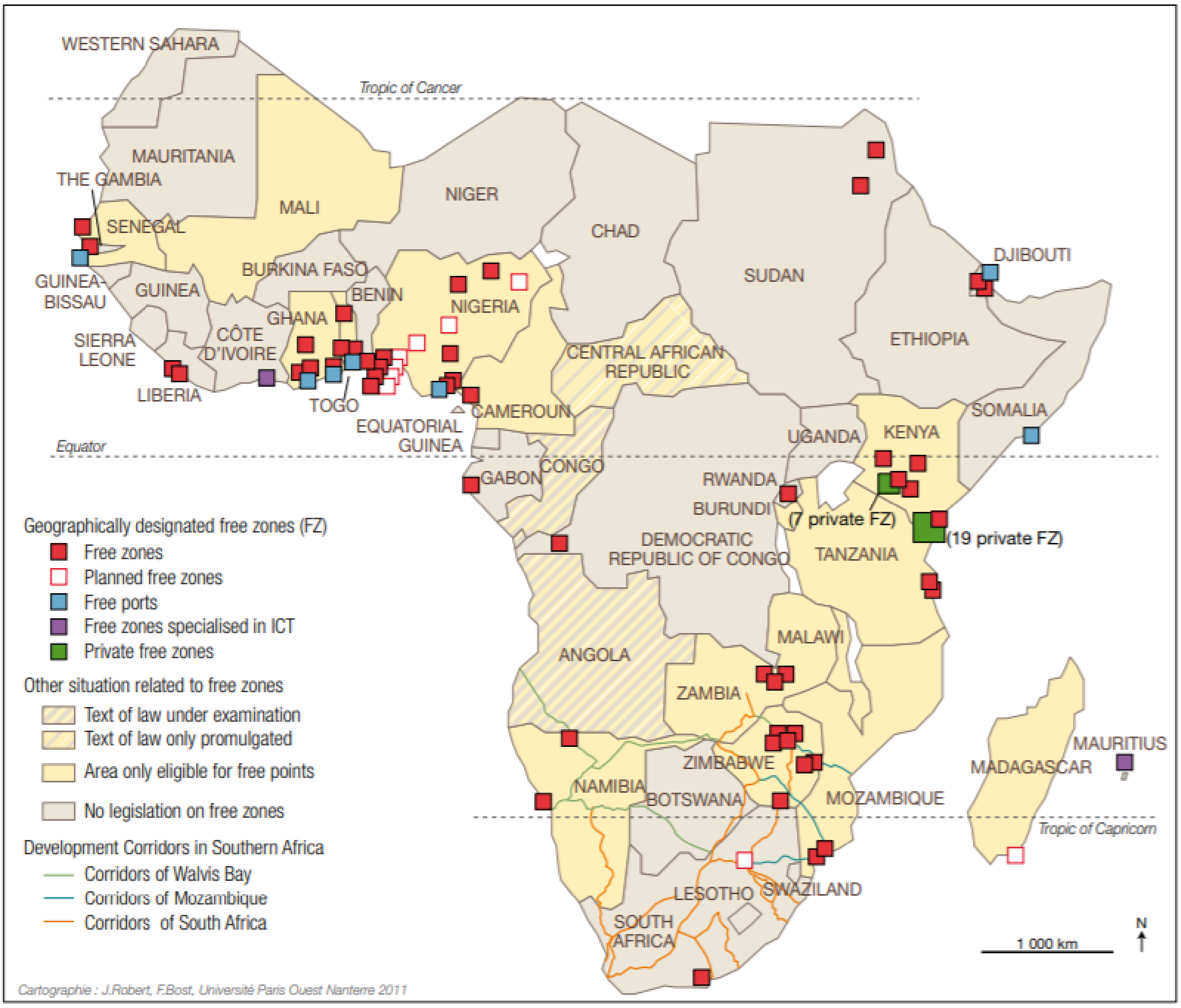
Firms in SEZs can be domestic, foreign, or joint ventures. Foreign direct investment plays a prominent role and SEZs can be publicly or privately owned or managed and can be “high-end” or “low-end,” depending on the quality of the management, facilities, and services they provide firms.

Firms in SEZs can benefit from direct fiscal incentives, but can also benefit from other benefits such as pooled resources for infrastructure that enhances the efficiency and effectiveness of operations within the SEZ (e.g. centralised waste management, a reliable electricity / energy supply, and seamless internet services), as well as administrative management assistance (e.g. “one-stop” processing of business licenses, and in-house customs offices).

[1] http://www1.worldbank.org/prem/PREMNotes/premnote11.pdf

Many African countries have made use of SEZs as Map 1 shows, although this map shows the situation in 2011, and there have been many more SEZs created since then.

Map 1: Special Economic Zones in Africa (2011)

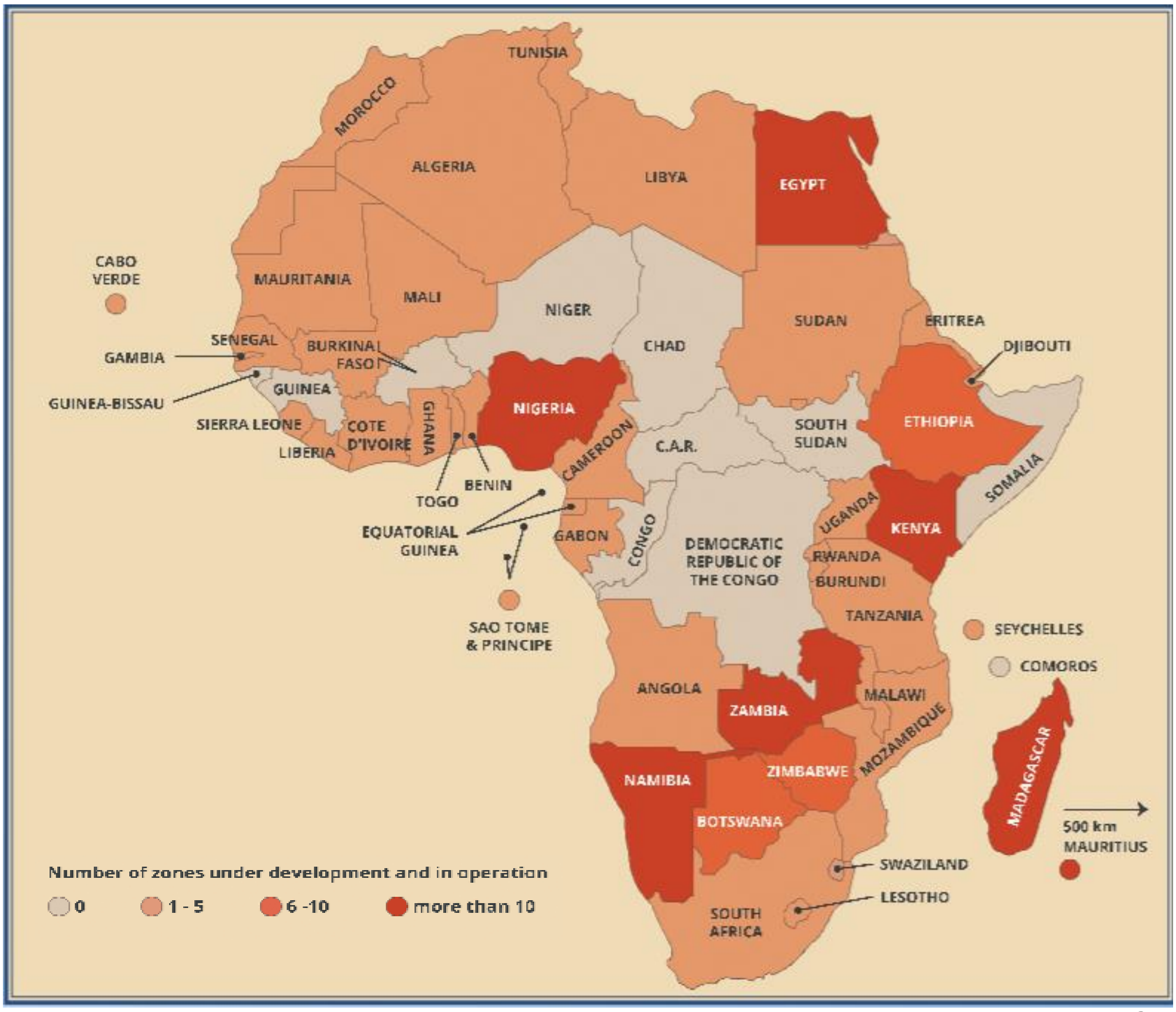


Source: https://www.oecd.org/swac/publications/49814045.pdf

By 2015 the situation had changed significantly as Map 2 shows. From 2011 to 2015 Ethiopia, in particular, had started to use SEZs extensively as a development tool and is in the process of building what the Ethiopia Investment Commission (EIC) refer to as "Plug-and-Play"[2] industrial parks. Each park is dedicated for specific sectors such as textile and apparel, leather and leather products, pharmaceuticals, agro-processing etc. and aimed at coordinated production along value chains.

[2] http://www.investethiopia.gov.et/investment-opportunities/strategic-sectors/industry-zone-development

Map 2: Special Economic Zones in Africa



Source UNDP - Comparative Study on Special Economic Zones in Africa and China. 2015[3]

2. SEZS, TAX INCENTIVES AND PREFERENCES

Available evidence suggests that African countries' experience with traditional SEZs has been relatively poor with respect to both employment generation and export performance. Many observers regard SEZs in Africa as "white elephants" that have only resulted in losing tax revenues because of preferences given, with no resultant significant increase in export earnings[4].

Work done by Stephan Van Parys[5] suggests that:

[3] http://www.cn.undp.org/content/dam/china/docs/Publications/UNDP-CH-Comparative%20Study%20on%20SEZs%20in%20Africa%20and%20China%20-%20ENG.pdf

[4] See, for example, "Enhancing the Contribution of Export Processing Zones to the Sustainable Development Zones. An Analysis of 100 EPZs and a Framework for Sustainable Economic Zones" UNCTAD 2015.

[5] The effectiveness of tax incentives in attracting investment: evidence from developing countries. Stefan Van Parys. https://www.cairn.info/revue-reflets-et-perspectives-de-la-vie-economique-2012-3-page-129.htm?contenu=resume

- foreign direct investment is less sensitive to the marginal effective corporate tax rate in countries with a relatively unattractive investment climate.
- lower corporate income tax (CIT) rates and longer tax holidays have shown themselves to be effective in attracting FDI in Latin America and the Caribbean but not in Africa.
- reduced complexity of the tax system and more legal guarantees help to attract investment in the CFA Franc zone.
- tax instruments to which firms are most sensitive - the CIT rate and tax holidays - are the ones on which governments compete the strongest.

A 2011 World Bank study[6] found that, taken as a whole, African SEZs had underperformed against their goals and objective measures of success, although there was some heterogeneity among countries. Other studies tend to confirm that African SEZs have underachieved, mainly because of a lack of competitiveness, poor governance, lack of resources and weak implementation capacity. Most cost-benefit analyses have concluded that SEZs are of marginal value as export promotion tools and have tended to be unsuccessful in African LDCs.

The KPMG publication "Investing in Africa – A Guide to Tax / Incentives in Africa"[7] documents the tax incentives provided by 32 of the 55 AU member states. The tax and other incentives that it documents include tax incentives to stimulate the national manufacturing, agricultural and industrial bases. The KPMG report notes that "African countries appear to be introducing new or revised incentives, seemingly to compete more favourably for both local and foreign direct investment".

The challenge is that many African countries provide investment incentives to companies in specific sectors that could be argued as being subsidies. These include investment capital allowances (including a percentage initial allowance on plant and machinery, scientific research expenditure, training expenditure, mineral exploration expenditure, initial allowances on buildings and deductible annual allowances); VAT refunds; duty and tax free import of plant, machinery and essential spare parts; duty exemptions for personal effects etc.

Tax credits, exemptions, or rate reductions can give direct benefits to a subset of taxpayers, who may not be in an SEZ, often as an incentive to take a particular action, such as encouraging companies to invest, develop infrastructure, or set up in disadvantaged regions. Such tax expenditures overall are non-trivial amounts of money, estimated at 2% of GDP in Ghana and 2.5% of GDP in Kenya and Tanzania[8].

However, before an assumption is made that a tax credit, exemption or rate reduction is financially beneficial to the recipient company it is important to examine the nature of the incentive. What is considered to be a wasteful giveaway as a tax expenditure in government budgets may not be a tax incentive for business. For example, a tax incentive comprising capital allowances, depreciation schedules, and VAT and import tax exemptions may be

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[6] http://documents.worldbank.org/curated/en/996871468008466349/Special-economic-zones-in-Africa-comparing-performance-and-learning-from-global-experience

[7] https://assets.kpmg.com/content/dam/kpmg/ng/pdf/tax/ng-incentives-in-africa.pdf

[8] https://www.cgdev.org/blog/good-bad-and-ugly-how-do-tax-incentives-impact-investment

regarded by the investor as the minimum expected structure of an "investment grade tax system" in relation to business expenses and treatment of losses and not an incentive.

It is also usual for countries to have VAT refund schemes in place for exported goods. Goods and Services Taxes (GST) such as VAT are designed to be a tax on final consumption which companies collect. When businesses are involved in export transactions for which no VAT is charged, or where they make large capital investments, they can end up in a position where they have paid out more in input taxes on their own purchases than they owe to the government, and thus are due a refund. It is also common to offer import tax reductions on capital goods. However, many countries lack a fully functioning VAT refund system (In the World Bank/PWC Paying Taxes study[9], 43% of countries with VAT systems did not give refunds) and tax exemptions are often used instead. While these can result in large on-paper tax expenditures, it should not be assumed that the normal counterfactual situation would be equivalent large VAT revenues for government.

From the above it can be seen that companies in SEZs or companies that receive what are interpreted as tax and investment incentives may not, actually be any better off – in terms of costs of production – meaning that they are not a source of unfair competition. This would make categorising all goods produced in SEZs as non-originating counter-productive and "unfair" in itself. If the intention is to address unfair competition in the ACFTA through rules of origin then all subsidised goods, not just goods produced in SEZs, need to, first of all, be proved to be not originating, which would, logistically, would be extremely difficult to do. It is suggested that if Members are concerned about unfair competition from subsidised goods, wherever they may be produced in SEZs, then it is more appropriate to address this "unfair" competition with purpose-built instruments such as the WTO agreement on subsidies and countervailing measures or inspired by it as detailed in the following section 3.

3. TREATMENT OF SEZ IN AFRICAN FTAS, OTHER FTAS WITH EU AND AGOA

[9] https://www.pwc.com/gx/en/paying-taxes/pdf/pwc_paying_taxes_2018_full_report.pdf

SEZs are treated differently in the various preferential trade agreements that African countries are signatories to as Table 1 shows:

Table 1: Rules of origin for SEZ-produced products in African FTAs

	Provision	Treated as originating?	Treatment of goods produced in SEZs or similar	Notes
ACP Cotonou	Protocol 1, Article 36	Yes	Granted preferential tariff treatment if Rules of Origin requirements of the Cotonou Agreement are met	
AfCFTA	Agreement on Establishment of the CFTA, Annex 2, Article 9	Yes	- Goods treated as originating if they satisfy the rules in Annex 2 and in accordance with the provisions of Article 23.2 of the Protocol on Trade in Goods - Parties must take all necessary measures to ensure products remain under the control of the Customs Authority and not substituted by other goods	See also Annex 2, Article 42: States parties agree that issues pertaining to Special Economic Arrangements / Zones and drafting regulations for goods produced thereunder are outstanding issues.
COMESA	Protocol on the Rules of Origin (2015)	Yes	Granted preferential tariff treatment if requirements of the COMESA Rules of Origin are met	
EAC	Protocol on the Rules of Origin (2015)	Yes	Granted preferential tariff treatment if requirements of EAC Rules of Origin are met	
ECCAS	No provision	No provision	No provision	
ECOWAS	Protocol A/P1/1/03, Article 7	No	Not granted preferential tariff treatment	
SADC	No explicit provision	No explicit provision	- No explicit provision	
TFTA	Tripartite FTA, Annex 4, Article 40	Yes (conditional)	- Granted preferential tariff treatment if requirements of TFTA Rules of Origin are met.	

Source: Derived by Author from various sources.

Table 2: Rules of origin for SEZ-produced products in agreements between African countries and Europe

	Provision	**Treated as originating?**
ACP-EU EPA (Cotonou Agreement)	Protocol 1, Article 36	Yes
EAC-EU EPA	No provision.	N/A
ESA-EU Interim EPA	Protocol 1, Article 40	Yes
SADC-EU EPA	Protocol 1, Article 42	Yes
West Africa-EU EPA	EPA between the EU and West African States / ECOWAS / UEMOA, Annex 2 (Protocol 1), Article 40	Yes
SACU-EFTA FTA	Annex V, Article 33	Yes

From the Tables it can be seen that most African RECs with the exception of ECOWAS do not apply restrictions on preferential treatment to product originating in SEZ. Nor the EU-EPAs with African RECs and AGOA[10] apply any restrictions on preferential tariff treatment for products originating under these arrangements. Besides this evidence it would be detrimental to AfCFTA objectives to exclude from AfCFTA preferential treatment products manufactured in SEZ. As example the same product manufactured in an SEZ in AfCFTA can be exported to EU and US with preferential tariff treatment while it will not be entitled to AfCFTA tariff treatment if limitation were to be introduced in AfCFTA for products originating in SEZ. As a result, such a provision would work as a disincentive to invest in SEZ for exports to AfCFTA markets, exactly the contrary of AfCFTA objective.

4. SUBSIDIES AND COUNTERVAILING MEASURES[11]

WTO Members are prohibited from subsidising exports and these provisions are contained in the Agreement on Subsidies and Countervailing Measures (ASCM).

The tax rebates and other kind of tax incentives granted to industries and firms located in SEZ may be considered as subsidies that may be prohibited or actionable as further detailed below.

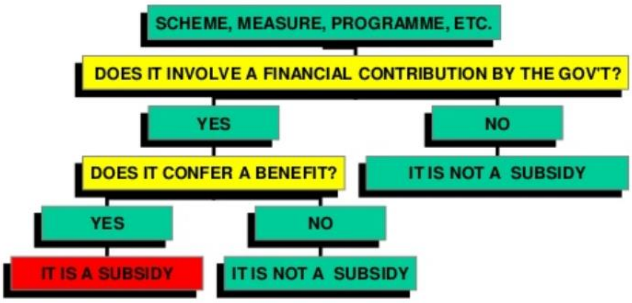
In the WTO ASCM subsidies are put into 3 categories using the “traffic light” system:

- Red (prohibited)
- Amber (actionable)
- Green (non-actionable)

A programme or action is deemed to be a subsidy if there is a financial contribution or income or price support by government or a public body which confers origin.

[10] AGOA has no explicit provision governing products originating in EPZ
[11] For sake of brevity this section contains a summary analysis of the WTO ASCM. Further refinements and qualifications may be carried out upon request by AUC or AU Member States

Box 1: Elements of a Subsidy:



Source: https://www.slideshare.net/finlawyer/subsidy20-presentation1

Subsidies may be simply prohibited under the WTO ASCM or may be actionable. Actionable subsidies means that such subsidies may exist but they may be challenged or countervailed according to the provision of WTO ASCM in place of countervailing .

Under Article 27.2a of the ASCM, the prohibition on export subsidies as set out in paragraph 1(a) of Article 3 shall not apply to developing country Members referred to in Annex VII.

According to Annex VII[12] of the ASCM, the developing country Members not subject to the provisions of paragraph 1(a) of Article 3 under the terms of paragraph 2(a) of Article 27 are:

- Least-developed countries designated as such by the United Nations which are Members of the WTO; and
- Other developing country Members with a GNP per capita less than US$1,000 per annum

However, Developing Country subsidised exports are potentially liable for countervailing duties, if the subsidies exceed the *de minimis* requirements contained in Article 27.10 of the ASCM which states that:

> *Any countervailing duty investigation of a product originating in a developing country Member shall be terminated as soon as the authorities concerned determine that:*
>
> *a) the overall level of subsidies granted upon the product in question does not exceed 2% of its value calculated on a per unit basis; or*
>
> b) *the volume of the subsidised imports represents less than 4% of the total imports of the like product in the importing Member, unless imports from developing country Members whose individual shares of total imports represent less than 4% collectively account for more than 9% of the total imports of the like product in the importing Member*.

Article 27.5 states that a developing country Member which has reached export competitiveness[13] in any given product shall phase out its export subsidies for such product(s) over a period of two years. However, Annex VII countries that have reached export competitiveness in one or more products should gradually phase out export subsidies over 8 years.

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[12] Annex VII includes many African countries - all LDCs plus Cameroon, Congo, Côte d'Ivoire, Egypt, Ghana, Kenya, Morocco, Nigeria and Zimbabwe

[13] Article 27.6 defines export competitiveness of a developing country Member as exports of that product that have reached a share of at least 3.25% in world trade of that product for two consecutive calendar years.

It can be understood from the above that, on one hand, the SCM WTO agreement ensure that subsidies do not distort trade and do not constitute unfair competition, and, on the other hand, Article 27.1 of the WTO SCM Agreement provides the following: "*Members recognize that subsidies may play an important role in economic development programmes of developing country Members*". It has to be noted that Developing countries and LDCs negotiating positions in WTO conceived their rights to maintain certain subsidy programs as part of *"policy space"*.

Since most AU Members are also WTO Members, or aspiring to be WTO Members, the WTO ASCM is the appropriate basis providing the legal trade remedies available to AfFCTA State Parties to address any unfair advantage that may be conferred by subsidies in form of tax holidays, rebates and incentives to firms located in SEZs. Article 2 of AfCFTA Annex 9 on Trade Remedies makes explicit reference to the WTO ASCM. Such provision may eventually be amplified to reflect such concern[14]. Finally it may be noted that Annex 9 provides for safeguard measures to help AfCFTA State Parties to adjust to some of the potential import surges, whatever the cause, not just imports from SEZs, that may arise when the AfCTFA Agreement is initially implemented.

5. CONCLUSION / RECOMMENDATIONS

In conclusion, it is recommended that:

a) The original Article 9 of the Annex 2 on Rules of Origin is maintained in its original form to grant AfCFTA preferential treatment to products originating in SEZs complying with AfCFTA rules of origin.
b) Issues related to unfair trade competition arising from subsidies granted to SEZs should be addressed using the WTO ASCM and the available provisions in AfCFTA Annex 9 on Trade Remedies.
c) Further clarification, benefits of SEZs to national economies and lessons learned from other FTAs on this topic, may be object of detailed studies if considered useful by AUC and Member States.

[14] It may be further considered and studied as other FTAs have treated WTO ASCM to reflect similar concerns.