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PREFERENTIAL RULES OF ORIGIN AND THE MULTILATERAL TRADING SYSTEM: PRO-DEVELOPMENT POLICY OPTIONS[1]

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PHILIPPE DE LOMBAERDE AND LUIS JORGE GARAY

1. Introduction

Since the proliferation of regional trade agreements in the late 1980s and early 1990s (the so-called new regionalism wave), preferential rules of origin (RoO) have also proliferated. The discussion on these rules gradually shifted from a purely technical discussion ('how to establish the origin of goods not wholly obtained in one country?', and hence, 'how to apply trade preferences in these cases?') to a wider discussion touching upon the transaction costs caused by having a 'spaghetti bowl' of rules, and also upon their actual or presumed neo-protectionist use.

In the context of the discussion on possible policy options for developing countries simultaneously involved in (or negotiating) regional and multilateral trade agreements, this note will, in section two, give a brief overview of the findings of the recent empirical literature. This section intends to show how informed and prepared we are to explore policy issues and formulate policy options. In section three, some indications are given on what such policy options could look like.

2. Recent Empirical Work on Preferential Rules of Origin: An Overview

Recent empirical work on preferential RoO falls roughly into three categories: (1) the development of analytical tools and mapping of different rules, (2) qualitative assessments and 'guesstimates' on the costs and effects of rules, and (3) statistical and econometric work on their effects.

2.1. Analytical Tools and Mapping

The rising complexity of preferential rules of origin has spurred the development of new tools – both conceptual and technical – to describe, assess and analyse the different sets of rules. The pioneering work of the Inter-American Development Bank should be mentioned in this respect (Garay and Estevadeordal, 1996; Garay and Quintero, 1997; Garay and Cornejo, 1999, 2001a, 2001b; Garay, 2002; Estevadeordal and Suominen, 2003a, 2003b, 2004, 2005, 2006). This methodological work on typologies and *ex ante* restrictiveness indicators has certainly brought some order to the spaghetti bowl and has allowed researchers to have a better grasp on RoO and to use the indicators in their econometric work on the effects of preferential rules. We are now also better equipped to communicate about RoO and inform policy makers about different policy options and their consequences.

From the mapping exercise, two important RoO clusters emerge to dominate the current landscape: the so-called Pan-Euro cluster and the NAFTA cluster – each configurated around a specific regulatory model.

In the Pan-Euro model, for each Harmonised System (HS) tariff heading there is a definition on what should be considered as sufficient working or processing for non-originating materials to qualify as originating goods. Contrary to previous protocols (Garay and De Lombaerde, 2006), a general rule is not provided. In many cases (about 25% of HS tariff headings), two criteria are proposed, of which at least one should be fulfilled. The first criterion can be a change of tariff classification (CTC) (CTH for more than 60% of HS tariff items), import content or a technical criterion. If there is a second criterion, it is import content. The Pan-Euro RoO include a so-called 'soft rule of origin' provision that allows the use of inputs at the same heading when the RoO requires a CTC at a heading-level or at a chapter-level, thus reducing the degree of stringency of the requirement. The Pan-Euro model includes provisions on *de minimis* operations and a (conditional) *de minimis* rule of 10% (e.g. non-originating materials up to 10% of the ex-works price do not alter the origin of the good), but there are some exceptions such as in textiles and apparel products. There are also roll-up rules and restrictive provisions on outward processing. Duty drawback is precluded to at least 2 years after signing the FTA. Bilateral and diagonal cumulation is

anticipated. Full cumulation was limited to the EEA. The EU's method of certification of origin provides two alternative procedures: a two step procedure in which RoO are certified by the government's agency once a certificate has been issued by the exporter or a competent agency, or an invoice declaration provided by exporters which have been approved as frequent exporters by the custom authorities.

In the NAFTA model, the required CTC varies from one good to another: a change in chapter, heading, subheading, or even tariff item may be required. The model is based on a multiplicity of criteria, which prevents any one criterion from being singled out as the guiding principle for determining origin. In part, this multiplicity reflects the high degree of detail and selectivity contained in the new generation FTAs. The NAFTA model often offers a variety of alternate rules for determining a good's origin, without each rule necessarily being based on a single qualification criterion. NAFTA and new-generation regimes tend to use net cost and transaction value as a method for calculating regional or national content. Estimating the value of regional content using the net cost method requires detailed records of and information on merchandise promotion and sales costs. *De minimis* clauses are expected to facilitate the regional integration of production processes by allowing the cumulation of regional components in calculating regional content values, and to streamline the origin certification process by enabling exporting companies to issue their own certificates. In addition, more detailed and precise enforcement provisions on verification, control, and sanction procedures are foreseen.

In terms of restrictiveness, the *ex ante* degree of restrictiveness of the NAFTA RoO regime is on average higher than that of the EU, except in a few sectors such as live animals, vegetable products, electrical equipment and optics (Estevadeordal and Suominen, 2003a, 2003b). But, both models are significantly more restrictive (ex ante) than first-generation RoO (LAIA, Indian Ocean model, see below) – both on average and at the sectoral level.

The NAFTA model is, however, not representative of RoO regimes on the American continent. Taking pre-existing preferential trade arrangements into account, the Americas show quite some diversity. On the other extreme of the spectrum of rules, the LAIA, Andean Community, Mercosur and CACM regimes show much lower levels of

ex ante restrictiveness than the NAFTA regime (Estevadeordal and Suominen, 2003a:35). They are generally characterised by the use of the CTC (generally applied across the board at HS four-digit level) or, alternatively, a given level of regional content. Only in some exceptional cases are a combination of criteria used for specific lists of goods. In these RTAs, when the choice of more than one rule to classify a good is foreseen, it is applied in a uniform way and each rule is based on a single qualification criterion. LAIA, Mercosur and the Andean Community require the FOB or CIF transaction values of the merchandise to be used as a method of calculating its regional or national content. In this respect, the CACM regime stands midway between the two extremes on the spectrum in the sense that it uses two methods to determine regional content: transaction value, defined in accordance with the WTO's Customs Valuation Code, and normal price, calculated from the FOB price of the exported goods and the CIF price of third-country components (Garay and Cornejo, 1999). The diversity of rules in the Americas has obvious implications for both intra-regional integration processes and inter-regional agreements, and negotiations such as those with the EU.

The RoO regimes of the preferential trade areas in the rest of the world include ASEAN, ANZCERTA, SAFTA, ECOWAS, COMESA, SADC and the Namibia-Zimbabwe FTA. These regimes are characterised by relatively simple rules, applied across the board. Usually a value content criterion is used, and sometimes the CTH criterion is used. The maximum import content varies from 30 to 70%, while the value content rule varies between 25 and 35% (Estevadeordal and Suominen, 2003a: table 6). Because of their similarity and the fact they refer to RTAs involving countries bordering the Indian Ocean (rather than because of any institutional connections) these models have been referred to as the Indian Ocean model (Garay and De Lombaerde, 2006).

The systematic mapping of RoO has also shed light on the dynamics of RoO regimes, their extra-regional expansion, and influence. Two transmission mechanisms seem to be at work. The first channel, the one usually focused on, is 'direct transmission', whereby the promoter(s) of rules in RTAs (EU, U.S.) apply the agreed rules to agreements with third countries. The U.S./NAFTA model has expanded southwards on the American continent, due to its application in U.S. FTAs and the use of the

NAFTA-type rules in 'new generation' agreements between other countries, including Mexico. However, at the same time, one can observe a tendency to simplify the new generation regime by reducing the cases subject to alternative rules, stressing the CTC as a predominant qualification criterion, and reducing the degree of *ex ante* restrictiveness in relation to the NAFTA original origin regime. This use of the NAFTA model would have been further reinforced if the FTAA would have succeeded. A similar tendency can be observed for the case of the FTAs the U.S. negotiated with countries on other continents, like Australia and Singapore. Contrary to the EU, the U.S. seems to have shown more flexibility regarding RoO, especially in the framework of extra-regional agreements. The U.S.-Jordan and U.S.-Israel FTAs, for example, basically rely on the value content rule (Moïsé, 2003b). The agreement with Israel therefore shows levels of restrictiveness significantly below the NAFTA level, thus and resembling more the Indian Ocean model in terms of restrictiveness. The U.S.-Singapore and Chile-Korea FTAs show more complexity. At the same time, the EU origin regime is finding application in FTAs concluded between the EU and countries such as Mexico and Chile, as well as other countries that negotiate FTAs with the EU (De Lombaerde, 2003). Further expansion of these dominant models can be expected with the negotiation and conclusion of new agreements by the EU (Economic Partnership Agreements [EPAs] with the African Caribbean and Pacific [ACP] states, EU-Mercosur, EU-Central America, Gulf Cooperation Council [GCC]), and the U.S. (SACU, bilateral agreements with Thailand, Colombia, Peru, Ecuador, Panama, etc). The level of restrictiveness of the RoO contained in these agreements has already been identified as one of the important determinants of the development effectiveness of these agreements (World Bank, 2005:32).

The second channel, 'indirect transmission', concerns cases where sub-hubs (Mexico, EFTA, South Africa, etc) introduce rules similar to those contained in their agreements with the hubs to agreements with third countries. This was the casein the EFTA-Mexico and EFTA-Singapore agreements, though the latter is slightly less restrictive. The SADC case probably also falls in this category as a case where a less restrictive regime is influenced by the development of more complex (and restrictive) regimes such as those of the EU and/or U.S./NAFTA. SADC rules initially consisted of a CTH, a minimum regional value content of 35%, or a maximum import content of 60% of total inputs. However, they were revised and now include more restrictive

content requirements; technical requirements have also been added (Flatters, 2002). The revision shows the influence of the rules embedded in the EU-South Africa agreement, and EU-ACP trade preferences (Schiff and Winters, 2003:8).

2.2. Qualitative assessments and 'guesstimates'

A second category of empirical work on RoO concerns qualitative assessments and 'guesstimates' of their costs and effects. These studies have shown evidence of administration costs of between 1.5 and 6% of export value; these numbers are significant, particularly when taking into account the fact that the total cost of RoO also includes the trade distortion effect. Prior to the efforts to harmonise the European RoO, the existence of divergent rules implied an important cost for the companies involved in international trade with the EU. This was especially true for RoO in the Europe Agreements, which were regarded as quite restrictive (Driessen and Graafsma, 1999:20-21). The (small) CEECs depended heavily on imported inputs, so the rules were often difficult to meet and the possibilities for cumulation were limited within the Visegrad or Baltic countries. The direct costs of administering the origin certification in the EC-EFTA FTA were found to be considerable. According to Koskinen (1983), these costs amounted to between 1,4 and 5,7% of export value; according to Herin (1986), they were between 3 and 5% of FOB export value. The move towards harmonisation clearly had a positive effect in terms of transparency and the possibilities for cumulation. Indeed, one of the outstanding features of the EU model is its high level of standardisation and harmonisation across the multiple FTAs signed since 1997, and the remarkable similarity and continuity since the first protocol was published in 1973. Although it is recognised that significant progress has been made in terms of internal logic and sourcing opportunities compared to the pre-existing protocols, Driessen and Graafsma evaluate the EU RoO system as still being complex. According to the authors, considerable tradedeflection was likely in different production sectors, given the origin criteria and the drawback prohibitions in trade with the CEECs (Driessen and Graafsma, 1999:37-39). The costs of administering the origin certificates in NAFTA have been estimated at around 1,8% of export value, while the trade distortion effect of the RoO is equivalent to an average tariff of around 4,3% (World Bank, 2005:70).

In addition to these guesstimates, specific cases such as textiles and fisheries have been described in detail.[4]

2.3. Statistical and econometric work

The third category of empirical work are statistical and econometric studies. These studies can again be sub-divided in three sub-categories. The first sub-category focuses on the following relationships: (i) relationships between degrees of restrictiveness and margins of preference (-); (ii) relationships between degrees of restrictiveness and the pace of tariff reductions (-); and (iii) relationships between degrees of restrictiveness and extra-regional tariff protection (+). These studies complement the case-studies previously mentioned, and often confirm the use of RoO for protectionist purposes. They also clearly show the linkages between RoO and the issue of market access. For example, Estevadeordal and Suominen (2004) have shown that the degree of restrictiveness of the EU RoO appears to be quite closely correlated with the pace of tariff reduction: the faster the tariff liberalisation schedule, *ceteris paribus*, the least restrictive the RoO. In other words, more restrictive rules are applied to products that previously benefited from higher levels of tariffs. Furthermore, the EU tends to eliminate tariffs faster for tariff lines in which the competitiveness of the EU's partner country is lower and/or its distance and transport costs for shipping to the EU are higher. This is the case with Chile, which obtained the fastest phase-out of tariffs among the latest extra-European FTAs (South Africa, Mexico and Chile). The NAFTA case also shows a correlation between the degree of *ex ante* restrictiveness of the rules and the tariff level applied to third countries (Garay and Quintero, 1997; Garay, 2002). For example, for nearly 80% of the tariff universe, the NAFTA RoO would seek to at least partially preserve the level of U.S. protection against foreign competition by imposing more restrictive origin requirements on imports from Mexico, when the U.S. tariff applied to third parties is higher. In addition, there appears to be an inverse relationship between the degree of restrictiveness of the NAFTA RoO and the margin of preference that the U.S. concedes to Mexico**,** but only for those items for which the Mexican tariff level is higher than the U.S. tariff level to third countries.

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[4] For a recent assessment of RoO within preferential trade agreements with Africa, see Brenton and Ikezuki (2005).

The second sub-category focuses on the relationships between the restrictiveness of RoO and the under-utilisation of trade preferences on the one hand, and on the relationships between the multiplicity of RoO and the under-utilisation of trade preferences on the other (Cadot et al, 2002). The cost of under-utilisation is thus measured in terms of trade flows or in terms of rent transfers to exporters. Restrictive RoO have been linked, for example, to the under-utilisation of EU preferences, thereby working against the development aims of some of the EU preference schemes (World Bank, 2005:52). Only about 50-55% of EU imports from countries with which the EU has a preference agreement actually benefit from the preference (European Commission, 2003a). Candau et al. (2004) found that, in general, under-utilisation of preferences did not constitute an important protectionist barrier for non-EU exporters. They did find, however, that the utilisation is generally correlated with the tariff margins, suggesting that compliance costs are significant. They also found exceptionally low utilisation rates for clothing and textiles under the EU General System of Preferences (GSP) and Everything but Arms (EBA) schemes, and identify restrictive rules as the main causes of this. Brenton and Ikezuki (2004) also confirmed that the low preference utilisation rates by the commercial partners of the EU in textiles can be linked to the restrictiveness of the RoO. With respect to the Africa Growth and Opportunities Act (AGOA), signed in 2000, Mattoo et al. (2002), and Walmsley and Rivera (2004), found that the medium term effects of U.S. trade preferences would be much more important without restrictive conditions on market access, and that RoO are the most important category of these restrictions. Clothing again appears to be a particularly problematic sector.

More recent evidence seems to confirm the potential positive effect of less restrictive rules on trade in the Middle East and North Africa (Dennis, 2006). Cadot et al. (2006) simulate the potential negative trade effect of adopting EU or U.S. style RoO to the ASEAN FTA.[5]

A third sub-category of econometric studies deals with the tradeeffect of cumulation provisions. Using gravity models, Gasiorek et al. (2002) estimated that the absence of

[5] See also Medvedev (2006).

diagonal cumulation reduces bilateral trade volumes by between 40-45%. A CGE analysis showed that RoO cumulation in the EU can be expected to lead to positive effects on intra-regional trade, output levels (+2 to 3%), and welfare (+ 0,5%). Estevadeordal and Suominen (2004) also demonstrated that cumulation has a significant impact on intra-regional trade. Recent evidence on the effects of cumulation in ASEAN and ASEAN-China FTA has been provided by Kuroiwa (2006).

3. Pro-development policy options

Moving now to the formulation of policy options, it seems that although clear policy prescriptions are lacking for both theoretical and operational reasons, there is a growing consensus on the need for less restrictive RoO for developing countries. The arguments that are used usually refer to the scale and development level of these countries, and to the re-structuring of the globalised production processes characterised by trans-border production chains.

The theoretical reasons for the lack of clear policy prescriptions are linked to the ambiguous results of the theoretical models (which are very sensitive to sector specificities), the possibility of optimal non-zero content requirements (i.e. an FTA with RoO producing a net positive welfare effect), and the problem of identifying the right benchmark (a sub-optimal CET?) (De Lombaerde and Garay, 2005). The operational reasons are linked to the existence of imperfect political markets and the inherent complexity of the RoO issue.

When exploring the policy options that might increase the gains for developing countries and further their insertion into the global and regional economies, one can distinguish between general (strategic) policy options and specific options related to the substance of the provisions.

General (strategic) policy options

The work programme on non-preferential rules has been undertaken by the Committee on Rules of Origin and a Technical Committee on Rules of Origin, under the auspices of the Customs Co-operation Council (CCC). But, little progress has been made and deadlines missed – due in no small part to a failure to agree on how to treat sensitive sectors such as agriculture, textiles and clothing (Schiff and Winters, 2003:31). A new work programme was agreed on in July 1998, and focused on problematic areas, including: the analysis of the implications of the harmonised RoO on other WTO agreements, discussion on product-specific rules, outstanding issues on product-specific rules, definitions, etc. The harmonisation work programme has been criticised on the grounds that a lack of human and technical capacity means that developing countries are not fully represented, with the result that their interests are not fully taken into account in the rule-making process (Lal Das, 2003). The new deadline in force for the Committee is December 2007. Ninety-three 'core issues' were forwarded to the General Council in 2002; the current deadline for these issues was July 2007 (WTO, 2006a). In recent meetings, the Committee on RoO also discussed preferential RoO and explored the possibilities for expanding the IDB mapping exercise towards incorporating all rules (WTO, 2006b). A convergence between the harmonisation process of non-preferential rules and a new initiative on regulating preferential rules is one possible scenario. This could lead to a multilateral agreement within the WTO on a common methodology for non-preferential and preferential RoO, as proposed by Garay and Estevadeordal (1996). Others, like Schiff and Winters (2003), and Estevadeordal and Suominen (2004), have also called for harmonised RoO based on non-preferential rules. An alternative but equally workable scenario would be to develop a new initiative on preferential RoO under the Committee on Regional Trade Agreements.[6]

An issue which deserves to be explored are the costs and benefits of a more ambitious and comprehensive effort to link the discussion on the origin of goods with the issue of origin in other areas of multilateral rule-making, such as services, trademarks, origin marking, anti-dumping, SPS, etc.

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[6] For example, linked to the work on a Transparency Mechanism for RTAs (WTO, 2006c).

Different scenarios lay open – the question is who will be the driving force(s) behind an initiative to regulate preferential RoO. An interest-driven multilateralisation process, as in the pan-euro case (Baldwin, 2006), probably cannot be repeated at the global level, although changes in the political-economy of RoO and in the attitudes of business interests in the economic centres (EU, U.S.) should not necessarily be excluded. The European Commission has recently done interesting work on rules and has presented some proposals (European Commission, 2004), but the process probably requires the pro-active involvement of the WTO and/or UNCTAD. This being said, the *de facto* proximity of the EU and NAFTA regimes should provide opportunities for convergence, and politicaleconomy forces might well contribute toward that. The role of the WTO and/or UNCTAD could be to provide independent information and analyses of RoO regimes and their effects, and to provide a platform for negotiation. If working towards (harmonised) compulsory rules (with or without exclusion lists) turns out not to be feasible, the drafting of voluntary rules to which RTA partners can adhere in the future could be envisaged. The WTO could present best practices for this purpose and they could work in a similar way to the models for bilateral investment treaties (BITs) which are emerging.

Specific policy options

Specific policy options refer to the substance of the rules provisions in RTA agreements. The aim of new regulatory initiatives should be to enhance the transparency of the rules and reduce the protectionist use that is made of them. This requires less restrictive and ambiguous origin criteria and restrictions on selectivity and multiplicity of rules.

In academic circles and policy circles in developing countries, the change of tariff classification at the HS four-digit level (CTH) emerges as the preferred rule thanks to its simplicity and transparency.[7] However, the construction of a consensus on this rule as a sort of rule-of-reference has been complicated by the recent Communication of the European Commission of March 2005, where a (sector specific) value-added criterion

[7] For a similar proposal in the context of the FTAA, see also Simpson (1997).

based on minimum local content as percentage of net production cost was put forward as the preferred rule (European Commission, 2005:9). As it is well known, the use of value-added criteria in low-income countries is particularly problematic because of its sensitivity to exchange rate variations, the perverse effect on the search for sourcing efficiency, and the perverse effect of local production efficiencies and low wages. Furthermore, estimating the value of regional content using the net cost method, as in NAFTA and new-generation regimes, requires detailed records of and information on merchandise promotion and sales costs. Using the FOB or CIF transaction values of the merchandise to be used as a calculation method for regional or national content is more appropriate, as these values are well known and they require neither the exporter nor customs authorities to keep special records or employ additional controls. As also suggested by Tralac (Naumann, 2005), replacing the (minimum) value-added criterion by a (maximum) foreign content criterion is also an option.

The use of more transparent and uniform rules could be combined with a sort of expanded *de minimis* rule, referring to the non-application of RoO below a certain tariff level, following Wonnacott (1996b).[8] This rule could even be agreed upon before any harmonisation of preferential RoO takes place.

Development-friendly rules should promote (diagonal, regional or full) cumulation and include roll-up clauses, with a double objective: to reduce the *ex ante* restrictiveness of rules and to support regional integration processes. The latter is already part of the EU philosophy behind cumulation clauses in its trade agreements with ASEAN, Andean Community, SAARC and in its GSP. Whether differential treatment should be considered in this respect and to what extent extra-regional cumulation should be foreseen (in order to stimulate South-South trade) should be explored, and go further than the EU position to restrict cumulation to 'coherent regional groups' (European Commission, 2005:10. The recent proposal from ACP circles to extend cumulation in its trade arrangements with the EU to the whole ACP 'area' might be an interesting test case.

[8] The current *de minimis* rules are between 10-15 percent in the EU FTAs and 7 percent in NAFTA (Estevadeordal and Suominen, 2003a; Garay and De Lombaerde, 2006).

Finally, as far as the streamlining of certification processes and the drafting of enforcement provisions (verification, control, sanctions) are concerned, a (delicate) balance should be struck between administration costs (for both public and private agents) on the one hand, and the expected gains in terms of the effective implementation of rules on the other. A package of capacity-building and the development of information systems might also help to improve the conditions for compliance with the rules and provisions in developing countries, although the potential and reach of these packages should not be over-estimated.

4. Conclusions

Recent years have left us with more sophisticated tools to assess the proliferation of preferential RoOs. In turn, these have made new statistical and econometric work possible, showing the transaction costs related to their complexity and their protectionist use at the cost of developing countries.

Hence, developing countries have an interest in more transparent and less restrictive preferential rules.

At the general/strategic level, a number of options lay open. The linkage or convergence between the work on the harmonisation of non-preferential rules and the discussion on preferential rules seems necessary. The added value of initiating a broader (horizontal) reflection on origin concepts in different areas should be explored. If new compulsory rules are not a realistic option, voluntary rules or principles might be an option. Finally, the political economy of RoO should be looked at more in detail, in order to develop realistic expectations as to the role of different players in promoting this agenda. The role of the EU is a bit ambiguous, to the extent that although the Commission initiated an interesting discussion on preferential RoO, the European position also reflects European business interests. An initiative by the WTO and/or UNCTAD would be welcomed.

As far as the reduction of the multiplicity of rules is concerned, the change of tariff classification seems to qualify as a consensus rule of reference, although the recent

European Commission document (favouring value-added rules) seems to have complicated this debate.

Another issue lies in the promotion of cumulation provisions. It remains to be seen how far North-South agreements will go to benefit the Southern partners and stimulate South-South trade.

Finally, further work is needed on a series of related provisions. The challenge here is to strike the right balance between administration cost, and the effective implementation of rules.

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