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Rules of Origin: Regimes in East Asia and Recommendations for Best Practice

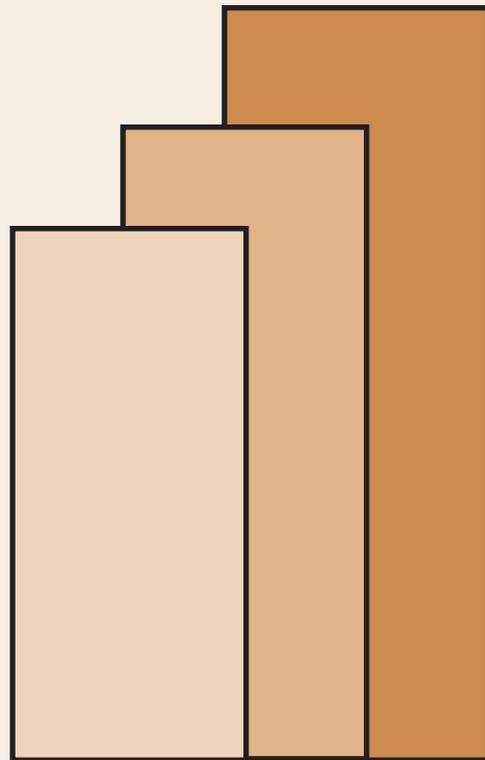
Erlinda M. Medalla

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For comments, suggestions or further inquiries please contact:

The Research Information Staff, Philippine Institute for Development Studies

5th Floor, NEDA sa Makati Building, 106 Amorsolo Street, Legaspi Village, Makati City, Philippines

Tel Nos: (63-2) 8942584 and 8935705; Fax No: (63-2) 8939589; E-mail: publications@pids.gov.ph

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Rules of Origin: Regimes in East Asia and Recommendations for Best Practice

Erlinda M. Medalla

Abstract

With globalization and advances in information and communication technology (ICT) leading to growing international production sharing, amidst the increasing trend in preferential trading arrangements (PTAs), rules of origin (ROO) has been beset with difficult recurring issues. First and foremost is the cost of ROO administration. Second, ROO as part of PTAs could generate new barriers to trade, thus taking with one hand what the other hand has given. In turn, this gives rise to another key concern: its potential use as a protectionist tool.

To achieve the East Asian vision of a community, any RTA it would endeavor to establish should set a rational, enabling regime of ROO that would facilitate even as it attempts to prevent trade deflection, with enough safeguards for inclusive development both within and across countries in the region. There is a consensus that the movement should be towards more simple and unrestrictive ROO.

In sum,

- Consolidation of the multiple membership agreements in the region around more liberal ROO should be the general guideline to achieve the vision of an East Asian community.
- Currently, majority of East Asia RTAs combine the three main ROO approaches: (1) the regional value added criterion- RVA, (2) the change in tariff classification- CTC and (3) specified processes (SP). Liberalizing features such as *de minimis* are in cases used, often in a product specific approach. Reliance on government certification is the general rule.
- The relatively simple and liberal ROO provision of AFTA, and the generality in application. In addition, reforms being sought lean towards more liberal rules by “expanding/easing standards”.
- The AFTA ROO would provide a good starting point for EAFTA.
- Necessarily, there should be a coordinated and cooperative action among member countries.

Keywords: rules of origin, preferential trading agreements (PTAs), free trade agreements (FTAs), regional trade agreements (RTAs), East Asia

Rules of Origin:

Regimes in East Asia and Recommendations for Best Practice*

*Erlinda M. Medalla***

1. INTRODUCTION

Throughout the globe, many governments have signed, are negotiating or are contemplating new regional or bilateral free trade and investment agreements. In general, there is consensus in principle that these agreements should be stepping stones toward full integration into a global free market, and keeping within WTO ideals is often explicitly articulated. In practice, however, there are risks about where these could eventually lead to. Political factors could intrude. Embedded vested interests could be created by the preferential trading arrangements which could become too resistant. The “noodle bowl” impact could prove difficult to unravel. And convergence into one single, larger (if not global) block may become impeded.

In the meanwhile, the more immediate problem is the complexity created by simply having multiple trading agreements, not just by the preferences offered, but by the rules of origin (ROOs) and the different regimes these rules are applied across agreements. In a nutshell, ROOs refer to rules used to define where a product was made. As straightforward as it may sound, determining origin within the context of international trade is not so simple. ROOs would involve laws, regulations and administrative determinations to ascertain a product’s country of origin which are not costless to comply with. In many cases, many steps, certifications, requirements are involved. And if different ROOs are used for different agreements with different partners, it is not difficult to imagine the intricate ‘noodle-bowl’ effect of these ROOs.

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** Senior Research Fellow, Philippine Institute for Development Studies

Hence, the type of ROOs, and how it is administered would play a crucial role in the global trading order. Even now, in East Asia (throughout this paper, this refers to the ten countries of ASEAN plus six countries including China, Japan, South Korea, India, Australia and New Zealand), there are apprehensions that the increasing number of FTAs is creating a complex and inconsistent web of rules of origin that could limit and/or distort the use of the trade preferences. These concerns are well recognized as manifested in the numerous studies and discussions covering the related issues, especially in recent years. See for example, Estevadeordal and Suominen (2003), Haddad (2007), Manchin and Pelkmans-Balaoing (2007), Kirk (2007) and Kawai and Wignaraja (2007).

The history of ROO is at least as old as the practice of discriminatory commercial policy by nation states (Harilal and Buena, 2003). ROO developed gradually with the development of differentiated tariffs and other trade measures and has been likened to domestic content requirements often imposed by developing countries. Over time, varying forms of ROOs have evolved for different purposes and across different trade regimes.

The growing importance of ROO issues in international trade and commerce is driven by a number of factors. *First*, the globalization of the means of production has made origin determination increasingly difficult and dispute prone.¹ Few products today are made solely in one country, or even within one enterprise, arising from the increasingly globalizing nature of international trade and commerce. Determining the ‘nationality’ of these products and the treatment under various international trading rules are crucial. *Second*, ROOs are a key element determining the magnitude of the economic benefits that accrue from RTAs and who gets them. *Third*, there is opportunity to make use of ROO as protectionist tool *per se*. There has been the increasing incidence of using ROO as discriminatory trade policy tool to protect domestic sectors and intermediate goods.

¹ What used to be a simple application of the origin of rules became complicated due to technological innovations in communications and transportation permitting the outsourcing by the companies of their manufacturing operations globally. Rarely can be seen a country claiming exclusive domestic inputs of a certain product (Coyle 2004).

Fourth, the various plurilateral and bilateral FTAs in East Asia give rise to the noodle bowl effect of a complex and possibly inconsistent web of ROOs, product standards and conformance requirements and diverse tariff liberalization schedules (Lazaro and Medalla, 2006).

Many critics have already noted the irony of the rules of origin negotiated as part of FTAs, appearing to take away with the left hand, what the right hand has given. There could come a point where the complex ROOs, in themselves, generate new barriers to trade. Haddad (2007), for example, has made the following observations about how ROOs fared in practice, even in the case of ASEAN whose ROO regime is considered to be among the least restrictive: (1) low AFTA preference utilization rate, (2) difficult compliance even for supposedly simple value-added rule, (3) administrative cost of compliance to prove origin acting as deterrent, (4) low margin of preference for goods traded within ASEAN, and (5) the bulk of intra-ASEAN trade occurring in commodities where preference margins are below the threshold that would justify the cost of compliance. (See Box 1.)

Due to the fall of MFN rates and the complexity of ROO invariably used in any FTA, some analysts question whether in fact there is an achieved market access afforded by the FTA. This is because what should have been a preferential access has been largely eroded by high compliance costs, supporting the suggestion that southern partners are effectively left on their “participation constraint”² (Anson et al. 2004). The steps prescribed and the nature of production technology imposed as an ROO by the other partner restricts market access and trade participation. For instance, in the case of American imports of apparel under NAFTA, the rule is one of “triple transformation.” Only if each step of the transformation from raw material to finished garment has been undertaken within the FTA will preferential treatment be given. This of course is beneficial to American textile producers because the other partner country would have difficulty in complying with such a requirement (Krishna and Krueger 1995).

² A term borrowed from contract theory meaning “just indifferent between signing and not signing”. (See Cadot et al. 2002.)

Box 1. Excerpt from Haddad (2007),” “Rules of Origin in East Asia: How Are They Working in Practice?”

AFTA preference utilization rates are low. ASEAN countries have implemented unilateral trade liberalization over the past two decades, and achieved low MFN rates (with average tariffs around 7 percent) by the time AFTA was implemented. This contributed to a limited impact of AFTA— today, less than 5 percent of intra-ASEAN trade makes use of the AFTA preferences. This is low compared with other FTAs. There are several reasons for the low utilization rates of AFTA: difficulty in satisfying the required value added requirement, difficulty in proving that the required value added has been satisfied, low preference margins, and high administrative costs of compliance. When the costs of complying with the rules of origin exceed the margin of preference then the trade agreement becomes irrelevant and trade will take place under the MFN regime.

The value added rule is simple in principle, but difficult to comply with. AFTA members, especially CLMV countries, are often unable to cumulate the necessary local/regional content. This is partly due to the high degree of production fragmentation in East Asia—half of its trade is in electronics and machinery where production networks are widespread. The import content (from outside ASEAN) of export is high, making it difficult to comply with the 40 percent valued added rule. Further, countries with low labor costs will find it more difficult to comply with a given value-added requirement than higher labor cost countries. The value added rule is also vulnerable to exchange rate fluctuations—any movement in the exchange rate leads to a change in import costs. This becomes problematic when the exchange rate fluctuations are widespread such as during the 1997 financial crisis. Moreover, the cost of proving origin is high. Computation of costs, invoicing, and other documentation demands inherent in the value added rule are complex, especially for smaller firms or firms from less developed East Asian countries.

The administrative cost of compliance to prove origin is a deterrent for the use of preferences. Surveys in a range of ASEAN countries highlight concern over the time and paperwork involved in obtaining Form D (official form to prove origin in AFTA), and the large amount of documentation required to prove origin (including invoices and other evidence to each input used in the final product). These problems are particularly acute for small firms and for firms for whom prompt delivery is a key element of competitiveness. The requirement that all Form Ds should be issued by designated government departments significantly increases the compliance costs compared to many other FTAs where private sector associations are permitted to issue certificates of origin. Estimates of the costs of requesting preferences within AFTA might be in the range of 10-25 percent—larger than those of other preferential schemes. Moreover, customs valuations differ across countries, pre-export inspections required by AFTA add to cost, transactions remain time-intensive and required face-to-face contact with officials, and incoming goods enjoying preferences are randomly subjected to post-audit checks.

Preference margins for products traded within ASEAN are low. Another reason for the low utilization rates of AFTA preferences is the low margin of preference on the products that are traded in large quantities within ASEAN... Intra- ASEAN trade is dominated by computer/machinery and electrical equipment where the tariffs are very low (around 1.5 percent), making AFTA preferences largely irrelevant. Products with the highest margins of preference typically have a low value of import as a share of total intra- ASEAN trade such that the 40% value-added rule of origin is a binding constraint to preferential trade. This is known as the snow-plough effect—in the AFTA agreement, vehicles especially designed for traveling in snow are given a high preference margin, but are irrelevant for ASEAN trade. Moreover, countries that confer the highest margins also appear to impose non-tariff measures on these same products (such as quantity control measures on certain categories of vehicles).

The bulk of intra-ASEAN trade occurs in commodities where preference margins are below the threshold that would justify the cost of compliance. Estimates based on other FTAs show that preferences start to have a trade stimulating effect only when preferential rates are at least 25 percentage points lower than the MFN rates. Over 90 percent of intra-ASEAN4 (Malaysia, Indonesia, Thailand, Philippines) trade occurs in commodities where preferences are below 25 percent—the threshold for using the preference. Only about 8 percent of eligible trade flows have a preferential margin above 25 percent (and are therefore “worth using”).

Because of the complex rules of origin, it becomes more profitable to alter production patterns simply to fulfill the rules for market access rather than reduce costs and improve efficiency (ADB 2002). Producers may be induced to shift their imports from low-cost third country suppliers to higher cost member sources or develop production facilities in the FTA partner (Krueger 1993). This creates a bias toward economic inefficiency, highlighting the negative effect of trade-diversion.

Another point of concern is the possible “privatization” of trade policy in certain cases due to its potential use as a protectionist tool, especially with using ROO in product specific cases. Individual industries and concerned industrial lobbies play a very important role in determining the level of protection including ROO. The cumbersome administrative process involved and the scope of involvement by the import competing interests, make the system less predictable as well as less transparent when compared to the overt methods of protection (Palmer cited in Haribal and Beena 2003).

Nonetheless, despite of all these issues, a regime of ROO is a necessary feature of any regional trading arrangement (RTA). Otherwise, “trade deflection” (the trans-shipment of products from non-members to FTA-members through a low-tariff FTA partner) could occur and the trade preference offered by the RTA is eroded. The ROO regime attempts to prevent trade deflection by imposing criteria that ensures an adequate degree of transformation in a preference-receiving country to justify allowing the good to benefit from the preference.

In moving toward the East Asian vision of a community, any regional trading arrangement it would endeavor to establish should set a rational, enabling regime of ROO that would encourage deeper economic integration and shared prosperity. This means a set of ROOs that is trade facilitating even as it attempts to prevent trade deflection, with enough safeguards for inclusive development both within and across countries in the region. Tough as this is, to complicate matters, it would have to deal with the proliferation of FTAs in the East Asian countries. As such it is necessary to take a look at

the different ROO regimes under different existing agreements in the region, and the implication of these simultaneous agreements on the integration of the regional markets.

This paper primarily aims to look for best practice which could be adopted eventually in the region by proposing best practice for East Asia. It aims to suggest a road map where the ROOs in the region would converge into one consolidated, consistent rule that would:

- Prevent trade deflection/circumventions
- Reduce cost of doing cross-border business and regional production,
- Encourage cumulation to promote intra-regional trade
- Incorporate development objectives.

It starts with a discussion of the different approaches to ROO in Section 2, and the recurring ROO issues in Section 3 to highlight key elements that need to be considered to formulate best practice ROO. Section 4 then provides an inventory and general assessment of the ROO regimes in existing East Asia RTA. Section 5 presents the conclusions and recommendations for best practice in ROO for East Asia.

2. APPROACHES TO ROO³

ROO refers specific provisions known as “origin criteria” that are established in international/regional trading agreements to determine the origin of goods being traded. Their importance has grown significantly as the number of preferential agreements grew, and countries increasingly have treated similar imported goods differently according to where the product was made (La Nasa 1995).

In general, there are at three (3) basic standards used to set ROO. These are:

- wholly obtained criteria,

³This part draws heavily from Lazaro, D. and Medalla, E.M. (2006). Rules of Origin: Evolving Best Practices for RTAs/FTAs. PIDS Discussion Paper Series No. 2006-01.

- minimal operation criteria⁴ and
- substantial transformation criteria⁵

‘Wholly obtained’ criteria would apply to goods that are clearly produced domestically. These are more easily identified and have clear HS (Harmonized System) nomenclature and coding. They are mainly in the first eight HS chapters covering mining, live animals, fruits, with some processing. Various agreements have more or less harmonized definition and identification of the HS codes covered. The three standards is usually reduced to two – as either wholly obtained or non-wholly obtained, as minimal operation criteria would usually be categorized as “wholly” obtained.

To provide an example, the ROO in ASEAN-CEPT is spelled out under a number of provisions as follows:

- Originating products: conditions 1) products wholly produced or obtained; 2) products not produced or obtained
- Wholly Produced or Obtained: List of qualified products
- Not Wholly Produced or Obtained: Products with at least 40 percent of its content originates from ASEAN Member States
- Cumulative Rule of Origin: Specific conditions
- Direct consignment: Specific conditions
- Treatment of Packing
- Certificate of Origin: issued by a government authority of the exporting Member State
- Review

⁴ For simple processing that is negligible in origin determination. Often, this would be lumped with “wholly-obtained” goods.

⁵ More than two countries are involved in the production of goods and their origin will be conferred upon the country where the last substantial transformation took place.

‘Substantial’ transformation is a generally accepted concept as a criterion for origin for non-wholly obtained goods. Among its advantages are flexibility, evolution over time, and development through application to specific facts in an adversarial situation where interested parties are represented. On the other hand the potential disadvantages include: inconsistent applications, discretionary nature and the costs of making an origin determination under it. The adoption or rejection of particular criteria of substantial transformation as a method of determining origin depends on which principle one puts more value on: *flexibility* or *certainty* (La Nasa 1995).

There are several approaches to defining whether ‘substantial’ transformation has occurred to satisfy originating criteria. In general, these include three major methods, used singly or in combination. The first is the *value-added measure (VA)*, which refers to the (minimum) percentage of value added created at the last stage of the production process (also the *domestic content test*)⁶. The second is the *tariff-heading criterion*⁷, also referred to as change in tariff classification (CTC), whereby origin is conferred if the activity in the exporting country results in a product classified under a different heading of the customs tariff classification of the Harmonized System of Tariff Nomenclatures, than its intermediate inputs. This criterion is comparatively simple and predictable, but trade classification systems have not been designed with the objective of distinguishing substantial transformation. The third is the *specified processes* or *technical test*⁸, which determines, on a case-by-case basis, specific production activities or specific processing

⁶ The value-added test yet simple and precise can be very costly because to comply with a value-added rule differences in calculation method, fluctuation in values and the compliance costs, the value-added rule requiring tracing, a manufacturer of a complex product would need a highly sophisticated inventory and accounting system to adequately ensure that particular goods contain specific local components at specific values (La Nasa 1995).

⁷ While the Harmonized System reflects the most sophisticated and refined tariff classification system, its primarily designed for the dual purposes of commodity classification and compilation of statistics (La Nasa 1995).

⁸ This is as good only as a supplemental test of origin because of its rigidity and difficulty of defining a process test for the enormous array of products made and the continuous need to update these rules for new products and technological advances in production. This process is also highly susceptible to capture by industry lobbying groups, because drafters and administrators would have to rely upon the industry for information. Lastly, negative technical tests leave large gray area, in that they only delineate which processes do not confer origin (La Nasa 1995).

operations that may confer originating status. This prescribes certain production or sourcing processes that may (positive test) or may not (negative test) confer originating status. (UNCTAD 2002) An example is the so-called *yarn forward (sometimes from fiber to fabric)* rule for textile and garment products.

The advantages, disadvantages and key issues using the different methods are highlighted in Table 1 below as summarized by Brenton (2003).

Table 1: Summary of the Different Approaches to Determining Origin

Rule	Advantages	Disadvantages	Key Issues
Change of Tariff Classification (in the Harmonised System)	<ul style="list-style-type: none"> ● Consistency with non- preferential rules of origin. ● Once defined, the rule is clear, unambiguous and easy to learn. ● Relatively straightforward to implement. 	<ul style="list-style-type: none"> ● Harmonised System not designed for conferring origin, as a result there are often many individual product specific rules, which can be influenced by domestic industries ● Documentary requirements maybe difficult to comply with. ● Can be conflicts over the classification of goods which can introduce uncertainty over market access 	<ul style="list-style-type: none"> ● Level of classification at which change required – the higher the level the more restrictive. ● Can be positive (which imported inputs can be used) or negative (defining cases where change of classification will not confer origin) test^a – negative test more restrictive.
Value Added	<ul style="list-style-type: none"> ● Clear, simple to specify and unambiguous. ● Allows for general rather than product specific rules 	<ul style="list-style-type: none"> ● Complex to apply – requires firms to have sophisticated accounting systems. ● Uncertainty due to sensitivity to changes in exchange rates, wages, commodity prices etc. 	<ul style="list-style-type: none"> ● The level of value added required to confer origin ● The valuation method for imported materials – methods which assign a higher value (eg CIF) will be more restrictive on the use of imported inputs
Specific Manufacturing Process	<ul style="list-style-type: none"> ● Once defined, clear and unambiguous ● Provides for certainty if rules can be complied with 	<ul style="list-style-type: none"> ● Documentary requirements can be burdensome and difficult to comply with. Leads to product specific rules. ● Domestic industries can influence the specification of the rules. 	<ul style="list-style-type: none"> ● The formulation of the specific processes required – the more procedures required the more restrictive ● Should test be negative (processes or inputs which cannot be used) or a positive test (what can be used) – negative test more restrictive.

Source: Notes on Rules of Origin with Implications for Regional Integration in South East Asia by Paul Brenton, 2003

There are other tests utilized for different types of products. Some FTAs also apply so-called “hybrid tests” which require both a minimum percentage of domestic value-

added content *plus* a change in tariff classification for a product to undergo a “substantial transformation” (Coyle 2004). On the other hand there is the more liberal either/or test, which provides a choice about which rule to use (alternative rule). Given that there are no internationally agreed standards, an importing country can vary rules of origin according to its trading partners and products.

Additional typical features of ROOs are also utilized to simplify or refine the process of conferring origin. Examples of these are provisions allowing a certain degree of *de minimis*, the roll-up principle and various types of cumulation. The *de minimis rule* allows for a specified maximum percentage of non-originating materials to be used without affecting origin. *Roll-up or absorption principle* allows materials that have acquired origin by meeting specific processing requirements to be considered originating when used as input in a subsequent transformation (Estevadeordal and Suominen 2003). Finally, cumulation (also known as *accumulation*) is a measure that permits countries to use inputs from a specific country or group of countries without affecting the origin of the products. In essence, cumulation provisions permit inputs to be obtained from *outside* the FTA and be counted as *domestic* for the purposes of determining the origin of the product (Coyle 2004).

There is a growing trend in the use of the cumulation⁹ type of ROO-- in particular, the *diagonal cumulation* which expands the geographical and product coverage of an ROO regime in FTAs. The traditional interpretation of this diagonal cumulation is to permit three or more countries to effectively merge their individual bilateral treaties into a single comprehensive FTA in which inputs can be sourced anywhere within the network. The issue raised however is whether this should benefit a non-party to the FTA as in the case of US-Singapore Integrated Sourcing Initiative (ISI) (Box 2) (Coyle 2004).

⁹ There are three types of cumulation. *Bilateral cumulation* operates between the two FTA partners and permits them to use products that originate in the other FTA partner as if they were their own when seeking to qualify for preferential treatment. *Diagonal cumulation* means that countries tied by the same set of preferential origin rules can use products that originate in any part of the area as if they originated in the exporting country. *Full cumulation* provides that countries tied by the same set of preferential origin rules among each other can use goods produced in any part of the area, even if these were not originating products (Estevadeordal and Suominen 2003).

Box 2. US-Singapore FTA: Integrated Sourcing Initiative (ISI) – from Statement made by US Ambassador to Singapore Frank Lavin.

The ISI, declared to be the “most significant economic aspect¹” of the FTA, exempts certain goods from having to “prove” that they originated in the United States or Singapore when passing through customs, thereby reducing the administrative costs associated with shipping these goods from one country to another.

The impressive level of economic integration in so-called growth triangle (Singapore-Malaysia-Indonesia), prompted the negotiators on both sides of US-Singapore FTA to include a means by which businesses operating in Singapore could continue to take advantage of the complementarities between Singapore and Indonesia. This means is now the ROO region known as the ISI. For example, if an Indonesian manufacturer (or any non-signatory third party WTO member for that matter) would want to export to US, even with zero tariff, it could consider exporting first to Singapore then to US to avail of the exemption from administrative cost of proving origin. Furthermore, the ISI in effect represents an opportunity for non-WTO members to take advantage of any variations in tariff rates between Singapore and United States.

ISI was seen as an additional step towards establishing a simplified global sourcing regime for certain types of IT products. It is also aimed at muting criticism of Singapore within the ASEAN for entering into FTA with United States by offering to other countries in the region the opportunity to take advantage of the FTA. On the other hand, this will also permit US multinationals operating in Singapore to capture existing complementarities within the Growth Triangle aside from limiting extra red tape, fees and paperwork (Coyle 2004).

2.1. ROOs in Textiles and Clothing

It is mainly with respect to sectors like textiles and clothing, agricultural and automotive products which are most especially sensitive to the type of ROO adopted. These are the sectors usually accorded higher tariff (and often also non-tariff) protection, leading to concerns of protectionist capture in the design of the ROO. (OECD 2002) Ironically, or maybe not, these sectors are also where the FTA would have highest impact. The ROO is especially relevant in the case of textiles and clothing given the elimination of quota allocation in the Multi-Fibre Arrangement (MFA).

NAFTA's ROO regime is particularly complex and the most complicated rules apply to special cases, including the so-called "maquiladoras"¹⁰ and the special regime covering textiles and clothing. The basic rules are so-called "yarn forward" and "fiber forward" rules according to which textiles and clothing products are deemed originating provided they are made of yarn or fiber produced in the area which would include all the cutting and sewing (Krueger 1993). Apparel products imported into the US must satisfy a "triple transformation" rule requiring domestic content at each one of three transformation stages: *fiber to yarn*, *yarn to fabric* and *fabric to garment* (Cadot et al. 2002). An examination of US ROOs would contain these rules although there are some 3rd country allowances to countries like Israel, Morocco and Jordan.

3. RECURRING ROO ISSUES

With globalization and advances in ICT (information and communication technology) leading to growing international production sharing, amidst the increasing trend in preferential trading arrangements, the administration of ROO has been beset with difficult recurring issues which are increasingly becoming an urgent concern.

- *Issue of Spaghetti (Noodle) Bowl Effect*

The technical nature of the ROO makes it *per se* difficult but the variations across FTAs (as discussed above) and the labyrinth rules make it even more problem-ridden. Precisely, it is the number and disparities of ROOs which give rise to the *spaghetti bowl effect*. Such overlap and inconsistency of the ROO systems must be addressed if one is to address trade facilitation issues.

¹⁰ *Maquiladoras* is a term referring to production units doing offshore assembly work for the US market. Generally, they are US owned companies enjoying preferential tariff treatment in the US before and even during the early years that NAFTA was formed (Cadot et al. 2002).

- *Cost of Administration*

Even without the spaghetti-bowl effect, costs of implementing ROO could be substantial. Estimates vary: 3 percent of the value of goods traded for EFTA countries (Herin, 1986), between 4-4.5 percent (Manchin 2006) and 6-8 percent (Cadot et al., 2005) for other EU schemes. For NAFTA, Carrère and de Melo (2004) estimates the cost of ROO to be around 6 percent of the value of goods traded. Manchin and Pelkmans-Balaoing, using a gravity model, finds that in ASEAN, for the preferential trade to positively influence trade flows, the margin of preference should be higher than 25 percent, suggesting an equivalent cost of ROO administration and compliance in ASEAN, much higher than estimates for EU and NAFTA.

Various ROO regimes would differ in their administrative requirements which would entail varying demands among exporters and importers alike. Compliance to the rules set may be difficult enough (whether VA, CTC or some other variation which would have different degree of restrictiveness). What more with a burdensome administrative process of verification and certification, and one that varies with the partner trading country. Usually, a certification serves as a verification of the origin of a given product. Hence, the type of certification adopted would have implication on the facilitation of trade. Some types (as in the case of EU's two-step system) require heavier involvement by the exporting country government and increase the burden of the exporters. On the other hand, there is the increasing adoption of a "self-certification" model (certified by a public or a private umbrella entity approved by the government) which entails lower administrative costs to exporters and government by transferring the burden of proof of origin to the importers themselves (Estevadeordal and Suominen 2003). However, this method could be too untraditional for most ASEAN countries and its acceptability may pose a problem.

Another issue aside from cost is the potential arbitrariness in the process. Verification of origin is generally done at the national level in accordance with guidelines agreed upon in the ROO of the FTA. This mechanism creates several sources of rents, as the

guidelines for valuing the final product and the domestic inputs are generally vague and can thus be manipulated and interpreted differently by national authorities, which have wide discretion in applying these rules (or even in the case of valuation of inputs), and can do so arbitrarily (ADB 2002).

In any case, the differences in the rules and how they are administered, not just across but within countries would entail confusion and more likely result in the limitation of potential market depending on its consistency with one's domestic policies. It is thus logical for countries engaging in numerous FTAs to adopt uniform rules of origin. Indeed, it makes coordination in ROO regimes in the region imperative.

- *ROO as a protectionist tool: differential impact of restrictive/lax rules*

ROO can either facilitate or restrict trade depending on the adoption of permissive or restrictive rules. In designing the ROO, a country can increase or decrease the degree of restrictiveness of ROOs using certain provisions—e.g., the preparation of a separate listing of operations that are in all circumstances considered insufficient to confer origin such as simple operations of cleaning, packaging and labeling; the prohibition of duty drawback which preclude the refunding of tariffs on non-originating inputs that are subsequently included in the final product exported to a FTA partner market; and the imposition of high administrative costs (Estevadeordal and Suominen 2003). In this regard, ROOs could be used as a protectionist trade instrument. Since ROOs are negotiated industry by industry, there is enormous scope for well-organized industries to essentially insulate themselves from the effects of the FTA by devising suitable ROO. Political variables that arbitrate the level of tariff and trade protection could come into the picture and affect the restrictiveness of ROOs. This has been suggested to be the case for developed countries, e.g., the EU and the United States. A report by Australian Productivity Commission found ROO laws under the two Australian FTAs (the United States and Thailand) are possibly among the most restrictive in world trade.¹¹

¹¹ www.news.com.au December 12, 2004.

Furthermore, agricultural products and textiles and apparels appear to have relatively more restrictive ROOs (Estevadeordal and Suominen 2003).

- *Issue of Investment diversion*

ROOs could be an important determinant of specialization patterns in preferential trade agreements. Restrictive ROOs could create an incentive to increase the amount of intermediate and final good manufacturing, processing and assembly done within the preferential area at the expense of the facilities in the other country which would otherwise have a comparative advantage. Firms base their decisions on production and location on country's trade protection creating an incentive for trade diversion in favor of a particular FTA to avail of the preferential treatment (ADB 2002). Furthermore, this may encourage intra-FTA producers to shift to suppliers in the cumulation area (Estevadeordal and Suominen 2003). This distortion causes an inefficient allocation of global resources (La Nasa 1995). For a larger FTA grouping with multiple members, ROO provision for cumulation would address this problem (at least as far as intra-regional allocation is concerned).

- *Treatment of Duty Drawback*

Related to the issue of trade and investment diversions is the treatment of the duty drawback. Most preferential agreements prohibit duty drawbacks granted to non-originating materials used in the production of a final product for export to partner country. This policy discourages the use of third country inputs in the production processes and thus contributes to allocation inefficiencies. In addition, it could be very important for countries with heavy production links with third party manufacturing networks. Clearly, the policy on duty drawback reflects ROO restrictiveness and protectionist tendencies of receiving countries. The most affected would be an exporting developing country partner.

These are just some of the major issues which the “new age” cooperation initiatives would need to deal with. Detailed issues about its administration can be even more important to actual trader and importer. Nonetheless, it is crucial that these general concerns be addressed in a rational framework when setting the best-practice ROO.

The next section looks at the different ROO regimes in East Asia. This would provide an idea about the initial conditions and how serious these issues are in the region.

4. INVENTORY AND COMPARISON OF ROO REGIMES IN EAST ASIA RTAS

There are currently at least 20 RTAs in East Asia. Bilateral FTAs involving East Asian countries, previously leaning more towards a multilateral (and unilateral) approach, have been rising in recent years. It would be difficult to keep track of the various bilateral arrangements especially those involving third-parties. As such, the discussion would focus mainly on ROOs not involving third party agreements.

ASEAN represents the largest grouping involving the East Asian countries considered in this paper. In addition, most of the other arrangements in East Asia would revolve around ASEAN, such the “ASEAN+1” agreements namely the ASEAN-China agreement, ASEAN-South Korea, and on-going negotiations between ASEAN and Japan; and as the East-Asia-wide initiative under the “ASEAN Plus Three” (APT) mechanism. More recently, there is also a proposal to forge a Comprehensive Economic Partnership of East Asia (CEPEA), a multilateral trade agreement that would encompass ASEAN Plus 6 (ASEAN+3 plus India, Australia and New Zealand).

In the case of bilateral agreements among East Asian countries, the most prominent are the various bilateral economic partnership agreement (EPA) being forged by Japan with individual ASEAN country, in parallel with its ASEAN-Japan track. This includes five which have been concluded and in force (with Singapore, Malaysia, Thailand,

Indonesia and Brunei). The Japan-Philippine EPA has been signed but as yet to be ratified by the Philippine Senate and Japan's EPA with Vietnam is in the process.

The inventory below would cover mainly the smaller East Asian grouping including ASEAN and the northeast countries of China, Japan and Korea. Nonetheless, the analysis, findings and discussion could easily be extended and would be applicable to all the 16 East Asian countries.

➤ ASEAN (AFTA) ROO

The AFTA ROO provides that:

- (i) A product shall be deemed to be originating from ASEAN Member States, if at least 40 percent of its content originates from any Member States;*
- (ii) Locally-procured materials produced by established licensed manufacturers, in compliance with domestic regulations, will be deemed to have fulfilled the CEPT origin requirement; locally-procured materials from other sources will be subjected to the CEPT test for the purpose of origin determination;*
- (iii) Subject to sub-paragraph (i) above, for the purposes of implementing the provisions of Rule 1 (b), products worked on and processed as a result of which the total value of the materials, parts or produce originating from non-ASEAN countries or of undetermined origin does not exceed 60 percent of the FOB value of the product produced or obtained and the final process of manufacture is performed within the territory of the exporting Member State.*

As observed by Estevadeordal and Suominen (2003), the AFTA ROO is prominent for its generality in application, originally utilizing just the single method of value-added criterion. It provides for 40 percent regional value added content (RVA) to qualify as originating good for non-wholly produced or obtained goods. At least on paper, the rule

is simple and relatively generous provision for imported inputs. The main reason for this is the reliance of most member countries on electronics and textile and garments for their exports, products produced within GPNs accounting for low value-added/local content, such that even 40 percent VA may be too high. Reforms of the ROO were sought to further clarify and simplify procedures so that in 2003, the AFTA decided in principle to adopt the CTC (change in tariff heading) rule as a general alternative rule to 40 percent RVA, starting with priority sectors based on private sector requests and those sectors prioritized by the AEM for accelerated integration (AFTA Council, 2003).

It has started to introduce CTC as a substitute criterion. Earlier product coverage is limited to: iron & steel products in HS Chapter 72, textiles and textiles products, wheat flour, aluminum and wood-based products. An increasing number of products are now being covered to apply CTC as alternative criteria to the VA rule for products in additional nine priority sectors, namely: (i) agro-based products; (ii) automotives; (iii) e-ASEAN; (iv) electronics; (v) fisheries; (vi) healthcare; (vii) rubber-based products; (viii) textiles and apparels; and (ix) wood-based products.

ASEAN is also further refining its cumulation rule and developing a “partial” cumulation approach-- that is, even goods of “partial” origin not having satisfied the 40 percent threshold can be cumulated as part of RVA. The practice in ASEAN is to count “components as part of ASEAN content which themselves have ASEAN content of 40 percent or more.” Upon recommendation during the September 2004 AFTA Council Meeting, the percentage content requirement was reduced to 20 percent of ASEAN content.

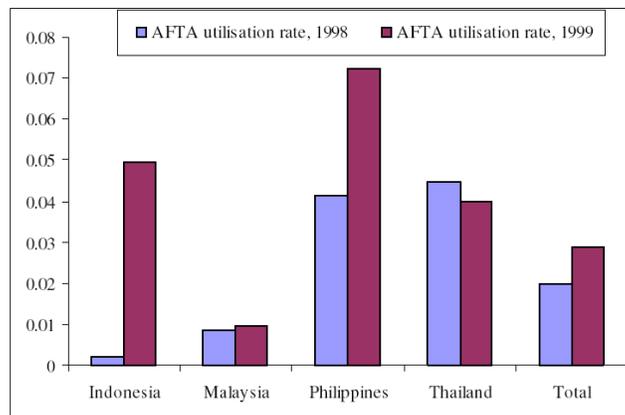
This move is envisioned to help most developing ASEAN member countries, whose sources of inputs, given the GPN structure would come from outside the region. Some estimates show that in most ASEAN countries, for major manufactured exports (e. g. textile, garments and electronics) total ASEAN content is less than 20 percent (Manchin and Pelkmanns-Balaoing, 2007).

Hence, in general, reforms to simplify the ROO are continuously being sought. However, there are no provisions as yet for the treatment of duty drawback or the Absorption or Roll Back principle.

The Issue of low utilization rate

Rules of origin, no matter how simple, would necessarily dampen the utilization rate of trade preference. Of course, the more complex it is, the larger the dampening effect. Indeed, such is the finding for AFTA. Despite the fact that as noted by many, AFTA ROO is among the simplest, CEPT utilization rates have been low. Some studies estimate that only about 3 percent of intra-ASEAN trade used the CEPT rates (Baldwin, 2006). JETRO reports that in 2002, only 11 percent of Thailand's exports to AFTA and 4.1 percent for Malaysia used the CEPT. This is far below the utilization rates in the EU which are rarely below 50 percent.

AFTA Utilization Rates



While a large part of this can be explained by the already generally low MFN tariffs of ASEAN, much would be due to practical reasons that yield high cost of administration and compliance. This implies a need to for continuous reforms in ROO.

JETRO (2004) on ASEAN's FTAs and Rules of Origin reports some improvement in the share of CEPT exports. It noted that the share of CEPT exports to total ASEAN

exports more than doubled from 10.8 percent in 2002 to 22.5 percent in 2003. This likely indicates better utilization of the CEPT preference. This could also indicate that reforms undertaken do matter.

➤ ASEAN + 1 ROO

In addition to the ASEAN Free Trade Area, ASEAN as a whole is also engaged with various Dialogue Partners to implement or discuss free trade areas under the “ASEAN plus” framework. Agreements have been signed with China (ACFTA) and Korea (AKFTA). Other dialogue partners for potential partnerships include Australia-New Zealand, India, EU and the United States.

Both ACFTA and AKFTA adopt the general 40 percent local/regional value added (RVA) rule, with full cumulation. They also provide for alternative rule using CTC for certain products. The progression from AFTA to ASEAN plus one, thus far, has been towards more flexibility (and thus less restrictiveness). The ACFTA ROO is more flexible (and less restrictive) than AFTA ROO covering a larger number of products with alternative CTC rule. These include 424 (HS6) textile and textile products items, 2 items of preserved fish, 6 items of wool, 22 of leather goods, 14 for furskins and 4 item lines of footwear. The AKFTA appears even more liberal with even larger product coverage allowed to use CTC as an alternative rule (except for a few cases in the automotive sector where the RVA requirement is 45 percent). It even introduces the novel approach of back-to-back Certificate of Origin (CO) for re-exports of partner A into partner B of products which was first exported by partner C into A, e.g. transit exports of Singapore from another ASEAN country (Manchin and Pelkmans-Balaoing, 2007).

A continuing trend toward a more liberal approach would bode well for the achievement of a best-practice East Asia ROO.

➤ Bilateral FTAs among East Asian countries

Among the northeast countries (China, Japan and Korea), Japan has been the most active in pursuing bilateral agreements with other East Asian countries, specifically ASEAN-6 and Vietnam.¹² Its strategy is to follow a dual track approach of forging bilateral partnership with individual ASEAN country along side negotiating an agreement with ASEAN as a group. A number of reasons have been cited, including the most practical one of threshing out first the details and difficult areas with specific countries, which would pave the way for a smoother implementation of an ASEAN-Japan partnership. The bilateral agreements forged by Japan with individual ASEAN countries are intended to be incorporated (as annexes) in the ASEAN-Japan FTA (AJEPA). If individual EPAs are not completed by the time AJEPA is concluded, the ROO will not be open to renegotiation.

The advantage of the dual track approach of Japan is the opportunity for one country to demand more flexible terms from Japan than what would otherwise happen in negotiating as a group. However, this is also a disadvantage since in all probability, a non-uniform outcome per industry across country would result, which would make consolidation difficult later on. While ACFTA and AKFTA are in essence also a series of bilateral agreements, with each country having bilateral negotiations with China and Korea in terms of preferences, at least, the ROO regime would be uniform per product. And as it turns out (as earlier discussed), what has emerged is even more liberal ROO regime than AFTA.

In examining Japan's bilateral with individual ASEAN countries, the trend is similar, although generally more restrictive. The earliest of Japan's EPA, that with Singapore, is indeed generally more restrictive than the newer EPAs of Japan. JSEPA (Japan-Singapore EPA) is characterized by particularly complex ROO especially for agricultural products, textiles and apparel (Manchin and Pelkmans-Balaoing, 2007). Majority uses

¹² Singapore and Thailand are of course more prolific, starting much earlier on in their pursuit of bilateral agreements, but Japan has been the more active with respect to forging partnerships with other East Asian countries, as Singapore and Thailand are already being a member of ASEAN.

mainly the change of tariff heading rule defined for specific products. Alternative RVC rule is allowed for a few products but at a high rate of 60 percent and where it is lower than 40 percent, the RVA rule is an additional rule. However, Singapore and to a lesser extent Japan, already have duty-free MFN status so that the ROO regime (and for that matter, the preferential treatment) is almost immaterial. *De minimis* is also provided for, but as a product specific rule.

Japan's more recent EPA has less restrictive ROO compared to JSEPA. The general rule is the CTC approach, defined for specific products, but in many cases, an alternative VA rule of 40 percent as in AFTA is used. As in JSEPA, there is provision for *de minimis*, but as a product specific rule.

Kawai and Wignaraja (2007) provide an overview of the main ROOs adopted by 30 concluded FTAs in East Asia. Their summary table is reproduced here as Table 2 below. Their study notes that majority of FTAs in East Asia (20) have adopted a combination of the three ROOs rather than applying a single rule. The AFTA and the ASEAN-PRC FTA use what they consider the simplest ROO—the VA rule, which specifies a 40 percent regional value content across all tariffs. They observe that the developed countries in East Asia, namely Japan, Korea and Singapore, tend to use a combination of ROOs, adding to the complexity and costs for business.

With respect to types of products, they provide some additional insights. For example, they note some variation in the case of major automotive and automotive parts in 11 major concluded FTAs (see Table 3- lifted from Table 10 of Kawai and Wignaraja, 2007). The VA rule is generally 40 percent for AFTA and ASEAN-China, but higher for ASEAN-Korea at 45 percent. The VA criterion is 60 percent in Japan-Malaysia for HS8703 and 8711 in contrast with 40 percent in Japan-Thailand FTA for the same two products. There are similarly instances in the case of Singapore-Australia FTA and Thailand-Australia FTA.

In sum, some key observations can be gleaned from examining the ROO regimes in the various FTAs in East Asia:

- The relatively simple and liberal ROO provision of AFTA, and the generality in application. In addition, reforms being sought lean towards more liberal rules by “expanding/easing standards”
- The existing FTAs in East Asia (again, limited to ASEAN-10 plus China, Japan and Korea) are more or less consistent with AFTA ROO, with the use of 40 percent RVA.
- Most sensitive sectors for most countries include automotive, textile and garments sectors.
- There is a trend toward using CTC as an alternative rule, albeit being defined for product specific countries.
- Japan appears to have greater tendency for more restrictive ROO.
- However, in general, there is a trend towards progressively more liberal ROO regime in East Asia.

Table 2. Rules of Origin of Concluded FTAs/a in East Asia, 2007

Agreement	Notes	Compared with AFTA (40%) VA rule
Value-Added Rule (VA) only (3 FTAs)		
1 Singapore-New Zealand Closer Economic Partnership Agreement (2001)	At least 40% of the cost is of New Zealand or Singapore origin, and the last place of manufacture is in New Zealand or Singapore	consistent
2 Singapore-Australia Free Trade Agreement (2003)	For manufactured products: (a) Local value-added (VA) content of 50% or (b) VA content of 30% for 114 tariff subheadings. These include electrical & electronic equipment and precision instruments.	some products more/less restrictive
3 Singapore-Jordan Free Trade Agreement (2005)	All products, <u>with the exception of textile and apparel goods</u> , need only fulfill a general rule of origin of a relatively low threshold of 35% local VA content. For textile and apparel goods, specific process rules apply.	less restrictive
VA and/or Change of Tariff Classification (CTC) Rules (3 FTAs)		
1 Taipei,China-Panama Free Trade Agreement (2004)	Regional VA content requirement: 35%, 40%, 45%	some products more/less restrictive
2 Thailand-New Zealand Closer Economic Partnership Agreement (2005)	Regional VA content requirement: 50%	more restrictive
3 PRC-Chile Free Trade Agreement (2006)	Regional VA content requirement: 40% or 50%	some products more restrictive
VA and/or Specific Product Rules (4 FTAs)		
1 Asia-Pacific Trade Agreement (1976)	Regional VA content requirement: 45% for most products. <u>Special Criteria Percentage</u> : Products originating in Least Developed Participating States can be allowed a favorable 10 percentage points applied to the percentages established in Rules 3 and 4 of APTA.	more restrictive

2	ASEAN Free Trade Agreement (1993)	Local or regional VA content of 40% or product specific rule for the following sectors: (a) Process criterion for textiles and textile products; (b) Change in chapter rule for wheat flour; (c) CTC for wood-based products; (d) CTC for certain aluminum and articles thereof.	consistent
3	ASEAN-PRC Free Trade Agreement (2005)	Regional or local VA content of 40% or product specific rule. Process criterion required for textiles and textile products.	consistent
4	PRC-Pakistan Free Trade Agreement (2006)	Regional VA content requirement: 40%	consistent

Combination of all Rules (VA, CTC, SP, others) (20 FTAs)

1	Singapore-European Free Trade Association (EFTA) Free Trade Agreement (2001)	Regional VA content requirement: 40% or 50%	some products more restrictive
2	Japan-Singapore Economic Agreement for a New-Age Partnership (2002)	For manufactured products, change in tariff heading (CTH) for all imported inputs used in the manufacture of the product; Singapore must be the place where the last substantial manufacture takes place. Additional flexibility for 264 products; CTH or local value-added content (VA*) of 60%.	more restrictive
3	Korea-Chile Free Trade Agreement (2004)	Regional or local VA content requirement: 30% or 45%	some products more/less
4	PRC-Hong Kong, China Closer Economic Partnership Arrangement (2004)	Local VA content requirement: 30%	less restrictive
5	PRC-Macao Closer Economic Partnership Arrangement (2004)	Local VA content requirement: 30%	less restrictive
6	Singapore-United States Free Trade Agreement (2004)	For manufactured products, (a) CTC for all imported inputs used in the manufacture of the product; Singapore must be the place where the last substantial manufacture takes place; (b) Regional value-added content (VA*) of 35-60% (applies mainly to electronic products); (c) Process rule (applies mainly to chemicals and petrochemicals).	some products more/less restrictive
7	Korea-European Free Trade Association (EFTA) Free Trade Agreement (2005)	Regional VA content requirement: 25%, 30%, 45%, 50%, or 60%	some products more/less restrictive
8	Singapore-India Comprehensive Economic Cooperation Agreement (2005)	Local VA content requirement: 40%	consistent

9	Japan-Mexico Economic Partnership Agreement (2005)	Regional or local VA content requirement: 50%, 65%, or 70%	more restrictive
10	Thailand-Australia Free Trade Agreement (2005)	Regional VA content requirement: 40-45 or 55%	some products more restrictive
11	ASEAN-Korea Free Trade Agreement (2006)	Regional VA content requirement: 40%, 50%, or 60%. Specific manufacturing process for textiles and garments.	some products more restrictive
12	Japan-Malaysia Economic Partnership Agreement (2006)	Regional VA content requirement: 40%	consistent
13	Japan-Philippines Economic Partnership Agreement (2006)	Regional VA content requirement: 40%	consistent
14	Trans-Pacific Strategic Economic Partnership Agreement (2006)	A product will qualify for preferential treatment if (a) it meets the specific rule of origin applicable to it (in many cases, this is a liberal CTH rule) or (b) where so stipulated, if at least 45% of the cost originates from the party.	more restrictive
15	Singapore-Panama Free Trade Agreement (2006)	Local VA content requirement: 35%	less restrictive
16	Korea-Singapore Free Trade Agreement (2006)	Regional VA content requirement: 55%	more restrictive
17	Japan-Thailand Economic Partnership Agreement (2007)	Regional VA content requirement: 40%	consistent
18	Japan-Chile Strategic Economic Partnership Agreement (2007)	Local VA content requirement: 30% or 45%	some products more/less restrictive
19	Japan-Brunei Economic Partnership Agreement (2007)	Regional VA content requirement: 40%	consistent
20	Korea-United States Free Trade Agreement (2007)	Regional VA content requirement: 35/45%; 40/50%; 55% (build-up/build-down method)	some products more/less restrictive

Note:
/a The list does not include Taipei,China-Nicaragua FTA; Laos-Thailand PTA; PTA of Group of Eight Developing Countries (PTA-D-8); Taipei,China-Guatemala FTA; PRC-Thailand PTA; and Taipei-China-El Salvador-Honduras FTA.

Source: reproduced from Table 9 in Kawai and Wignaraja, 2007. ASEAN+3 or ASEAN+6: Which Way Forward?

Table 3. Rules of Origin for Major Auto and Auto Parts Products in Selected East Asian FTAs

FTA	Japan- Malaysia (2006)	JAPAN	Japan- Thailand (2007)	KOREA	PRC	AFTA (1993)	ASEAN	ASEAN- Korea (2006)	SINGAPORE	Singapore- United States (2004)	THAILAND	
		Japan- Singapore (2002)		Korea- Singapore FTA (2006)	PRC- Pakistan FTA (2006)		ASEAN- PRC (2005)		Singapore- Australia (2003)		Thailand- Australia (2005)	
HS Code	Product Description											
87.01	Tractors (other than works, warehouse equipment)	CTH (6 digit) or RVC of 40%	CTH; last substantial manufacture*	CTH or RVC of 40%	CTH plus RVC of 55%	RVC of not less than 40%* or a CTH (4 digits)*	VC of not less than 50%*	CTH plus RVC of at least 30% (build up)	CTH plus RVC of 40%			
87.03	Motor vehicles for transport of persons (except buses)	CTH or RVC of 60%	CTH; last substantial manufacture*	CTH or RVC of 40%	CTH plus RVC of 55%	RVC of not less than 40%*	RVC of not less than 40%*	RVC of not less than 40%*	RVC of 45%	Last process of manufacture within territory of the party	CTH plus RVC of at least 30% (build up)	CTH plus RVC of 40%
87.04	Motor vehicles for the transport of goods	CTH or RVC of 50%	CTH; last substantial manufacture*	CTH or RVC of 40%	CTH plus RVC of 55%	RVC of not less than 40%*	RVC of not less than 40%*	RVC of not less than 40%*	RVC of 45%	VC of not less than 50%*	CTH plus RVC of at least 30% (build up)	CTH plus RVC of 40%
87.08	Parts and accessories for motor vehicles		CTH; last substantial manufacture*	CTH or RVC of 40%	CTH plus RVC of 50%/55%	RVC of not less than 40%*	RVC of not less than 40%*	RVC of not less than 40%*	RVC of 45%	Last process of manufacture within territory of the party	CTH (6 digit) or CTH plus RVC of at least 30% (build up)	CTH (6 digit) plus RVC of 40%
87.11	Motorcycles, bicycles, etc. with auxiliary motor	CTH or RVC of 60%	CTH; last substantial manufacture*	CTH or RVC of 40%	CTH plus RVC of 55%	RVC of not less than 40%* or a CTH (4 digits)*	VC of not less than 50%*	CTH (4 digit) or CTH plus RVC of at least 30% (build up)	CTH (6 digit) and/or RVC of 40%			
87.14	Parts and accessories of bicycles, motorcycles, etc.	CTH or RVC of 40%	CTH; last substantial manufacture*	CTH or RVC of 40%	CTC (4 digit)	RVC of not less than 40%* or a CTH (4 digits)*	VC of not less than 50%*	CTH (6 digit) or CTH plus RVC of at least 30% (build up)	CTH (6 digit)			

Notes: The general rules of origin of the FTA are adopted when there is no Specific Product (SP) rule provided. CTH=Change of Tariff Headings; RVC=Regional Value Content; VC= Value Content.

Source: lifted from Table 10 in Kawai and Wignaraja, 2007. ASEAN+3 or ASEAN+6: Which Way Forward?

5. CONCLUSIONS AND RECOMMENDATIONS

Complex ROOs are associated with increased administration costs to governments and transactions costs to business firms. Moreover, multiple ROOs in overlapping FTAs are particularly burdensome, giving rise to the “noodle bowl” effect. The textile and garment sector is particularly affected by stringent and restrictive ROOs.

Estimates of ROO costs vary. Herin (1986) estimated the cost to be around 3 percent of the value of goods traded for EFTA countries. Manchin (2006) estimated a range between 4-4.5 percent and Cadot et al. (2005) between 6-8 percent for other EU schemes. For NAFTA, Carrère and de Melo (2004) estimated the cost of ROO to be around 6 percent of the value of goods traded. Manchin and Pelkmans-Balaoing, using a gravity model, finds that in ASEAN, for the preferential trade to positively influence trade flows, the margin of preference should be higher than 25 percent, suggesting an equivalent cost of ROO administration and compliance in ASEAN, much higher than estimates for EU and NAFTA.

JETRO surveys in ASEAN countries note the considerable amount of time and paperwork involved in obtaining Form D (the official form to prove origin in AFTA). Compliance with ROO involves numerous documentation requirements (including invoices and other evidence for each input used in the final product). These problems are magnified for small firms. In addition, ASEAN requires that Form D should be issued by designated government departments, unlike many other FTAs where private sector associations are allowed to issue certificates of origin. The 2006 JETRO Survey of Japanese Firm’s International Operations shows that around 30 percent of 97 Japanese MNCs surveyed using or planning to use FTA preferences in East Asia view the existence of different rules of origin as complicating their trade businesses and leading to increased costs—either through having to deal with complicated procedures to prove country of origin or even having to change to productions processes. Another 33 percent expected to see increased costs in the future. Furthermore, 64 percent of firms thought that rules of origin should be harmonized, with the largest number (24.7 percent)

preferring to be able to choose either the value added (VA) rule or the change in tariff classification (CTC) as the common rule. Thus, it seems that multiple ROOs are beginning to manifest themselves as a problem in East Asia (Kawai and Wignaraja, 2007).

How then is the vision of an East Asian community to be achieved? What ROO regime would be an enabling factor that would facilitate trade among members and augment intra-regional trade and investments flows? The answer depends primarily on whether the ROO regime would lead to the reduction of the cost of doing business across the region and promote seamless trade and production. In this regard, the discussion above suggests some key features of such a regime.

- *Simplicity and Efficacy*

There is a consensus that the movement should be towards more simple and unrestrictive ROO. Simpler ROO will help promote regional trade and international competitiveness of member states. Simple rules will reduce compliance costs and administration itself of trade and customs procedures. To minimize the potential for unproductive rent-seeking and corruption, a simple and transparent ROO is important (ADB 2002).

In general and in theory, this means using a single, least restrictive rule. But in practice using an either/or approach might be more practical.

In this regard, the use of CTC as an alternative (either/or) method to the VA rule would help. The CTC method is easy for Customs authorities to implement. At the same time, SMEs might also find it easier to comply with, simply needing to show import and export invoices with different classification code. The question is determining the level of disaggregation the member countries would deem to satisfy “substantial” transformation, which would vary across commodities. Here, protectionist tendencies would surface and agreements (especially between developed and developing countries)

might be difficult. Nonetheless, the general rule should lean towards less restrictiveness. This implies using a common rule across products, possibly at a 4 to 6-digit level, and if any, with very limited product-specific exemptions.

The reforms in ASEAN ROOs appear to be heading toward this direction. It has started to introduce CTC as a substitute criterion. Earlier the product coverage is limited to: iron & steel products in HS Chapter 72, textiles and textiles products, wheat flour, aluminum and wood-based products. An increasing number of products are now being covered to apply CTC as alternative criteria to the VA rule for products in additional nine priority sectors, namely: (i) agro-based products; (ii) automotives; (iii) e-ASEAN; (iv) electronics; (v) fisheries; (vi) healthcare; (vii) rubber-based products; (viii) textiles and apparels; and (ix) wood-based products.

Japan's latest bilateral agreements with ASEAN countries have similar elements—predominantly CTC, with alternative use of VA for most. The problem would be the different levels of disaggregation used and it is doubtful how liberalizing the regime could be. In any case, it appears that Japan's plan is to more easily consolidate the ROO into a Japan-ASEAN ROO.

Another suggestion being considered in various FTAs is the use of self-certification. It is not without its own problem, as previously mentioned, but this would simplify and lighten the administrative burden considerably.

Finally, *de minimis* rules (which allow for a specified maximum percentage of non-originating materials to be used without affecting origin) can greatly simplify ROO. It could be set well within a level for the intent and purposes of “substantial transformation” but a higher cut-off would represent a more liberal approach to ROO.

While the use of *de minimis principle* appears to become a common feature in newer partnership agreements, upon closer examination, application is usually on a product

specific (PSR) basis. A wider application of *de minimis* rule using generous ceiling would be a major step to simplifying ROO and lowering the cost of compliance.

- *Flexibility*

Internationalization of production and accompanying technological changes would require periodic revision of the ROO, especially in product groups where technologies and production processes change fast. ROO should be flexible enough to accommodate these changes. Nonetheless, product specific rules should be avoided. Otherwise, there would be a tendency of “privatization” of trade policy brought about by the need for periodic revision. There should at least be some well-defined procedures or guiding principles for introduction of amendments in the harmonized ROO. Again, in practice, an either/or approach might be useful.

- *Accumulation Rule*

One important consideration is the adoption of a full cumulation type ROO. Full cumulation is an important factor allowing for the development of regional production networks. This provides for deeper integration and allows for more advanced countries to outsource labor-intensive production stages to low-wage partners. Coupled with simple ROO, this full cumulation will make it easier for regionally-based firms to exploit the economies of scale (Brenton 2003).

ROO provision for cumulation (referred to as well as accumulation) would be a crucial feature to include in a regional trading agreement. It would address problems of protectionist tendency in the ROO and investment (and trade) diversion effects, at least within the wider grouping of member countries. An issue is how to deal with non-member countries. To what extent should cumulation be allowed so as not to frustrate the preferential status of the FTA partners? Should this follow the traditional Pan-European system or the more aggressive US-Singapore ISI? What combination of policies or rules

is acceptable? The easy answer is to include a guiding principle, for example, a development dimension in these rules involving simple interpretation.

Aside from accumulation, roll-up or absorption principle which allows materials that have acquired origin by meeting specific processing requirements to be considered an originating good when used as input in a subsequent transformation could also be recommended for a more liberal ROO approach.

For its part, ASEAN is developing a “partial” cumulation approach. The practice in ASEAN is to count “components as part of ASEAN content which themselves have ASEAN content of 40 percent or more.” Upon recommendation during the September 2004 AFTA Council Meeting, the percentage content requirement was reduced to 20 percent of ASEAN content.

This move is envisioned to help most developing ASEAN member countries, whose sources of inputs, given the GPN (global production network) structure, would come from outside the region. Some estimates show that in most ASEAN countries, for major manufactured exports (e. g. textile, garments and electronics) total ASEAN content is less than 20 percent (Manchin and Pelkmanns-Balaoing, 2007).

- *Harmonization of Customs Procedure*

Customs clearance is still a problem in most of the less developed countries of East Asia. A complex ROOs accompanying a free trade agreement can further complicate rather than facilitate trade in the region. Along with harmonization of ROO standards, there is even greater need for the streamlining of customs procedures and simplification of customs clearances including the introduction of paperless trading in many FTAs. The objective is to minimize documentation costs. Harmonization of customs procedures in general would be a big step in this direction. This is consistent with the principles of predictability, transparency and consistency required in the ROO.

• *Developing country Dimension*

Establishing an international regime of ROO is one thing. Ensuring that it does not pose disadvantages to developing countries is another. There is a need to add this dimension to the ROO regime. Arguments against free trade, competition policy and the like are a result of lack of safeguards for those who are not prepared to participate and more so compete.

Developing countries need to be able to latch on to the GPN. This means gearing the ROO regime towards the preparation, development, and internationalization of SMEs. The ideal ROO therefore should have a developing country dimension. What would this entail? Needless to say, capacity building is crucial, for exporters, importers and administrators in developing countries, if the region is to achieve the best practice in the rules of origin. Developments in the EC for development-friendly ROO includes a single value-added method, use of statement of origin by registered exporters, and training and technical assistance to improve evaluation, information flows and monitoring of compliance. Another key element is allowing alternative means of proving origin more suited to the development stage of the developing country member.

A logical concession to developing member countries is to lower the VA criteria for its exporters. Findings for the EU shows that a decline in the value-added requirement would tend to increase utilization rates. This could be a most useful incentive for CMLV countries.¹³

¹³ The value-added requirement should be based on whether the potential gains in terms of greater regional trade significantly outweigh the risks of trade deflection. Kirk (2007) suggests 30% value-added requirement would be sufficient to prevent significant trade deflection.

In sum,

- Consolidation of the multiple membership agreements in the region around more liberal ROO should be the general guideline to achieve the vision of an East Asian community.
- The ASEAN ROO is considered relatively simple and liberal. The generality in application is also a plus factor. In addition, reforms being sought lean towards more liberal rules by attempts toward “expanding/easing standards.” However, a lot remains to be done to improve the system.
- The existing FTAs in East Asia (again, limited to ASEAN-10 plus China, Japan and Korea) are more or less consistent with AFTA ROO, specifically with the use of 40 percent RVA.
- In general, there is a trend towards progressively more liberal ROO regime in East Asia.
- As such, especially with continuous effort to clarify and improve issues of implementation, the AFTA ROO would provide a good starting point for EAFTA.
- Necessarily, there should be a coordinated and cooperative action among member countries.
- Rules toward adopting full cumulation, and roll-up (absorption) process should be developed. *De minimis* provisions should be applied more extensively. These would be significant impetus for deeper regional integration.
- Sensitivity – applying restrictive ROOs targeted at sensitive products is not an effective mechanism for protecting domestic industry and should be limited.
- Special and Differential Treatment: ROO be devised by taking into account the different levels of development of countries in the East Asia region, e.g., using lower value added content

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