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Rules of Origin: Evolving Best Practices for RTAs/FTAs

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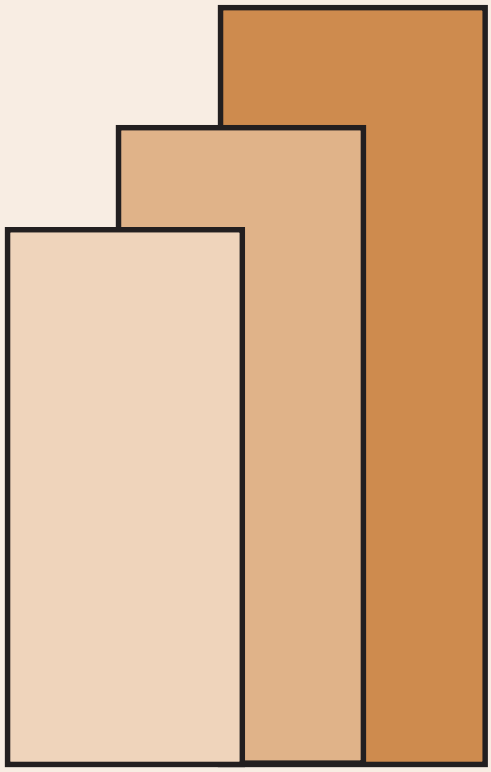

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Abstract

The paper aims to add to the understanding of the issues and suggests a framework to move towards the use of best practice in ROOs.

Rules of Origin (ROO), originally designed as uncontroversial and neutral devise for authentication and statistical purposes, have evolved over time to accommodate different purposes which come about with new technologies and other developments, across different trade regimes. ROO is becoming a tool in implementing discriminatory trade policies and trade policy instrument *per se.* ROO has become a critical and to some extent, a "dragging point" in the negotiation process of recent trade agreements. The growing relevance of ROO in trade negotiations cannot be overemphasized.

The paper begins with the definition that has been adopted and traces the developments in the use of ROOs. It looks at ROOs within the context of multilateral rules of origin and the preferential ROO in Regional or Bilateral FTAs. Different types of ROO with some illustration from existing RTA are also presented. The paper also focuses on some recurring ROO issues, and presents some suggestions for a framework for ROO best practices which is characterized by *transparency, predictability, neutrality,* and *non-discrimination*, and with the added dimension of being development-friendly.

keywords: Rules of Origin (ROO), free trade agreement, WTO, regional integration

Rules of Origin: Evolving Best Practices for RTAs/FTAs*

*Dorothea C. Lazaro and Erlinda M. Medalla***

> "Rules of origin, because they affect who gets *what, when and how*, are intrinsically political. They can exhibit, in accentuated form, the political imbalance that can tilt overall trade policy toward restrictiveness and against the maximization of national welfare."--*I.M. Destler (2003)*

1. Introduction

The term Rules of Origin (ROO) actually speaks for itself, referring to the rules which determine the origin of goods in international trade. However, because of the varying definitions that have been used, ROOs are generally perceived as technical and incomprehensible set of trade rules. This paper aims to add to the understanding of the issues and suggest a framework to move towards the use of best practices in ROOs. To this end, the paper has six major parts. The introductory section presents the general definition that has been adopted and traces the developments in the use of ROOs. The next section looks at the ROO in the multilateral context particularly how it fits within the WTO framework. Section 3 proceeds with the discussion on the preferential ROOs in Regional or Bilateral FTAs[1]. The next section then presents the different types of ROO with some illustration from existing RTAs. Section 5 then focuses on some recurring ROO issues, before providing some inputs for a framework for ROO best practices in Section 6.

- *ROO Definition*

The most commonly used definition of ROO is that set of rules which determine the "nationality" of a product traded in international commerce. Under the World Trade Organization (WTO) definition, ROO refers to the criteria used to define where a product was made.[2] In general, ROOs exist as an essential part of trade agreements since there is a need to distinguish between different foreign sources of a given product. (Coyle 2004) The importance of ROO has grown significantly as preferential agreements expand and countries have treated similar imported goods differently according to where the product was made. (La Nasa 1995)

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[1] FTA means Free Trade Agreement and in this paper used interchangeably with RTA or Regional Trade Agreement.

[2] Specifically, the General Agreement on Tariffs and Trade (GATT) defines *ROO* as "those laws, regulations, and administrative determinations of general application applied by any Member to determine the country of origin of goods, provided such ROO are not related to contractual or autonomous trade regime leading to the granting of tariff preferences going beyond the application of paragraph 1 of Article 1 of GATT 1994".

The history of ROO is at least as old as the practice of discriminatory commercial policy by nation states. (Haribal and Beena 2003) Beginning in the early twentieth century, ROO developed gradually with the development of differentiated tariffs and other trade measures. (La Nasa 1995) ROO has been likened to domestic content (preference) requirements often imposed by developing countries, for instance, for fiscal or foreign equity eligibility. In the case of ROOs in a free trade agreement, import tariffs on the final good is reduced, provided that "required" inputs (according to the defined rules) come from the FTA member. (Preferential bias is thus for both output and input use.) (Krishna and Krueger 1995) Over time, varying forms of ROOs have evolved for different purposes and across different trade regimes. At the very least, ROO form an important additional function for eligibility to preferential tariff concessions.

Theoretically, without a ROO, imports would seek entry through the country with the lowest tariff. If the rules would simply provide that some value should have been added in the country of origin, a simple labeling or packaging of the product would qualify an item for duty-free entry to the other country. (Krueger 1993) Thus, the economic if not the main justification for preferential ROO is to curb trade deflection.[3] The preferential ROO attempts to prevent trade deflection by establishing criteria that ensures an adequate degree of transformation in a preference-receiving country to justify allowing the good to benefit from the preference. (La Nasa 1995)

Parenthetically, ROO also exist for authentication and statistical purposes. Traditionally, ROO take into consideration different components: *origin component; consignment standards* and *documentary standards*. Compliance with consignment standards satisfies authorities that products shipped from beneficiary countries are the same at the port of disembarkation (such that no manipulation, exchange, dilution or third country trade of products has taken place). The documentary standards require that adequate documentation of origin and consignment be submitted. (ICEG __)

- *Growing relevance of ROOs in trade negotiations*

Rules of origin were originally designed as uncontroversial, neutral devise primarily to implement the aforementioned purposes. In recent times however, ROO have become more of a tool in implementing discriminatory trade policies and has become trade policy instrument *per se.* ROO has become a critical and to some extent, a "dragging point" in the negotiation process of recent trade agreements.[4]

ROOs' rise to prominence is generally attributed to three important factors: *First*, the globalization of the means of production has made origin determination increasingly

[3] *Trade deflection* occurs where companies place a minimal processing or assembly-plant in a preference-receiving country to take advantage of those trade preferences.

[4] In the NAFTA, the exact specification of the ROO was one of the last sticking points of the agreement. In the negotiation, US was supporting a stringent ROO while Canada and Mexico were in favor of a lower percentage and a broader definition. This made evident that US' attempt to provide protection to some US producers in the Mexican market- exporting American protection despite low Mexican tariff rates. It is noteworthy that Canada agreed to the higher ROO only after the United States accepted a revision of the way is which FTA value added is calculated where the US agreed to include interest and other capital costs, as well as labor costs. (Krueger 1993)

difficult and dispute prone.[5] *Second,* the increasing incidence of discriminatory trade policy tools has resulted to a consequent need to determine the country of origin so that they can be effectively targeted. *Third,* the growing tendency to make use of ROO as protectionist tool *per se,* as devices supporting more overt trade distorting policy tools. (Haribal and Beena 2003)

Several other circumstances have provided countries the opportunity and incentive to use (or misuse) their ROO to implement trade policies in an obscure manner. Among others are the increased disparate treatment of similar goods, the growing number of restrictions placed on the use of traditional tariff and non-tariff barriers to trade by the General Agreement on Tariffs and Trade (GATT), the lack of regulation of ROO (prior to the GATT), and the technical obscurity in which ROO operated. (La Nasa 1995) It is such misuse that necessitated the Uruguay Round agreement on the ROO to minimize the trade distorting effects of recent purposes of ROO schemes.

- *ROO as Trade (Restricting) Instrument*

Many critics have already noted the irony of the rules of origin negotiated as part of FTAs where the staggering complexity of origin regimes often themselves generate new barriers to trade. There are quite a number of arguments where an ROO can be instruments of intra-bloc protection and thus restrict what is an otherwise envisioned as free trade. Since the liberalization of tariff barriers, countries have turned to narrowly drawn ROO as the second-best means of providing a measure of protection to domestic industries. (Coyle 2004)

Due to the fall of MFN rates and the complexity of ROO that invariably accompany all FTAs, some analysts suggest that although there are non-traditional gains, there is doubt as to whether in fact the enhanced market access afforded by the FTA is achieved. 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[6]." (Anson et al 2004) The prescribed steps and the nature of production technology imposed as an ROO by the other partner sometimes 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 NAFTA will preferential treatment be given. On one hand, it is beneficial to American textile producers but on the other hand, the producers of the other partner country (specifically Mexico) would have difficulty in complying with such a requirement. (Krishna and Krueger 1995)

One other example is the very strict requirements of the highly technical rules that EU stipulate products exported which have made it difficult for the many preferential

[5] What used to a 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)

[6] A term borrowed from contract theory meaning "just indifferent between signing and not signing"). (See Cabot et al 2002)

trade partners of the EU to meet. This restrictiveness is also compounded by the costs of actually proving origin. The costs may even be higher and positively prohibitive in countries where customs mechanisms are poorly developed. (Brenton and Manchin 2002)

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) Hence, producers alike are 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 becomes a trade diversion case which creates a bias toward economic inefficiency. An illustration is a country with a zero-tariff level pre-FTA could find its producers post-FTA diverting their imports from low-cost third country sources to the partner country in order to be eligible for FTA treatment. (Krueger 1993)

Another important feature of protectionism based on ROO is the so-called "privatization" of trade policy. 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, makes the system less predictable as well as less transparent when compared to the overt methods of protection. (Palmeter cited in Haribal and Beena 2003)

2. Multilateral Rules of Origin

One important principle underpinning the WTO is that of non-discrimination or the *most-favoured nation* clause (MFN principle)[7]. This principle requires a WTO member to give the same level of treatment to all WTO Members (albeit with certain exceptions like that of a FTA or RTA). Comes now the question as to the relevance of ROO in multilateral level especially if given that under MFN, zero tariff is imposed.

It should be kept in mind that even with the elimination of tariff barriers, there remains various non-tariff (administrative) costs of trading goods which differ across countries. One approach is to look at the *substitutability* between tariffs and ROOs. (Cabot et al 2002) Compliance with ROOs either preferential or non-preferential entails additional costs relative to the kind and origin of a particular good. The primary difference thus lies between tariffs and administrative costs. Secondarily, it depends whether such rules are applied multilaterally or preferentially.[8]

- *Global Harmonization of ROO*

The growing significance of ROO as well as the growing complexities of the rules have caused concerns among many as to its trade distorting effects. This has prompted economists and government bureaucrats to make efforts to minimize if not to thwart the

[7] The MFN principle is articulated in GATT:1994, *supra,* Article I: General Most-Favoured Nation Treatment.

[8] For instance, although tariff rules are clearly covered by Article I of the GATT, whether the so-called administrative costs in FTAs are covered by the phrase "other regulations of commerce" in Article XXIV remains a question.

effect of the "spaghetti bowl phenomenon[9]." This is the source of fears that the increasing number and expanding coverage of FTAs would result to confusion and difficulties in the administration of overlapping and mutually inconsistent rules of origin requirements. This issue has in fact found its way in the international discussions and efforts were initiated to harmonize origin rules at the global level.

- *Before the Uruguay Round*

The first attempt to harmonize ROO was in 1953, through the efforts of the International Chamber of Commerce (ICC) when it submitted a resolution to the Contracting Parties to GATT recommending the adoption of a uniform definition for determining the nationality of manufactured goods. Under the proposal, a product resulting *exclusively* from labor and materials and labor of two or more countries would originate in the country where the product last underwent a substantial transformation. The definition of substantial transformation- which is listed processing that confers a new individuality on the goods, however was for political reasons, not adopted by GATT.[10] (La Nasa 1995)

In the 1970s, another effort for the global harmonization of rules of origin was made. The World Customs Organization (WCO) adopted the Revised Kyoto Convention, an international instrument to standardize and harmonize customs policies and procedures around the world. (Estevadeordal and Suominen 2003) This covers both preferential and non-preferential ROOs, recognizing two basic criteria to determine origin: based on principles of wholly obtained goods and substantial transformation that countries would use in drafting their own ROO. This rule of origin for goods wholly obtained in the originating country has been adopted repeatedly by other trade agreements. (La Nasa 1995) In the 1974 International Convention on the Simplification of Customs Procedures, it provides that the "origin" of the product is the country where the last "substantial transformation" took place. (Coyle 2004)

- *The Uruguay Round*

For many years, the GATT contained no specific provisions on rules of origin other than Article IX (which deals with marking requirements) as well as GATT's general provisions, such as Article I (MFN Treatment) and Article XXIV[11]. The ROO as a potential non-trade barrier to trade has not been directly addressed in the WTO until 1994 in the Agreement on Rules on Origin (ROO Agreement). (Coyle 2004) The inclusion of an ROO in the Uruguay Round negotiation has been attributed to the claims that European Communities use ROO to implement politically motivated, trade restrictive and

[9] As coined by renowned economist Jagdish Bhagwati, "Spaghetti bowl effect" may arise due to the differential tariff rates for FTA member and nonmember countries. Thus, the "spaghetti strands" may emanate out of many different and overlapping directions, with consequent negative welfare effects.

[10] This is because some countries wanted a standard international definition of origin and uniform rules for determining the origin of imported goods while another group was skeptical of any kind of international definition of origin because origin was considered to be *inescapably bound up with national economic policies*.

[11] Section 5 provides that FTAs shall not increase restrictions on trade with Members who are not parties of the FTA or customs union.

trade distortive formulations and interpretations. (La Nasa 1995) Needless to say, it can be said that left alone, the inclusion of ROO in the multilateral agreement is inevitable and is only a matter of time because of the growing trade relevance of ROOs.

- *The ROO Agreement*

The ROO Agreement was intended to harmonize all the *non-preferential* ROO used by signatory countries into a single set of international rules. (La Nasa 1995) A product specific ROO evolved during the negotiation which put forward specific criteria for substantial transformation with the predominant issue as to *what will* or *will not* qualify for substantial transformation. Members however have inconsistent positions across product groups with respect to this. Negotiating positions across product sectors are determined by the corresponding national trade interests rather than by any common principle to be adopted in a uniform manner. (Haribal and Beena 2003)

The ROO Agreement provides for four (4) basic principles as follows:

(1) *Non-discrimination.* ROO must apply equally for all purposes of *non-preferential* treatment;
(2) *Predictability.* ROO must be objective, understandable and predictable;
(3) *Transparency.* ROO must not be used directly or indirectly as instruments to pursue trade policy objectives; and
(4) *Neutrality.* ROO must not, in and of themselves, have a restrictive, distorting or disruptive influence on international trade.

On the other hand, Annex II[12] of the Agreement sets down a number of disciplines applicable to ROO in *preferential* regimes, which provide that ROO should clearly define requirements for conferring origin; based on a positive standard; published in accordance with GATT Article X:I; and applied prospectively.

At this point it is important to note that the Agreement distinguishes (if not focused on one) between preferential and non-preferential ROO. This is relevant taking into consideration the difference of the two general types of ROO.

- *Preferential vs Non Preferential*

ROOs are classified into two types, one being preferential, and the other non-preferential. The latter may even be divided further into two: one with respect to unilateral preference like the developed country's general system of preference (GSP) and second involving bilateral or regional trade agreements. As defined earlier, *preferential ROOs* prescribe the conditions under which the importing country will regard a product as originating from an exporting country that receives preferential treatment from the importing country. Simply said, ROOs determine whether a good qualifies for preferential treatment when exported from one member to another. On the other hand, *non-preferential ROOs* are used to distinguish foreign from domestic products for the purposes of application of anti-dumping and countervailing duties, safeguard measures,

[12] Common Declaration with regard to Preferential Rules of Origin, Annex II of the Agreement.

origin marking requirements, and/or discriminatory quantitative restrictions or tariff quotas, government procurement, and statistical purposes.

It is quite discernible the harmonization efforts in the WTO through the ROO Agreement are actually limited and effective to the extent of non-preferential ROOs. For instance the prohibition on the use of ROOs as instruments to pursue trade objectives, directly or indirectly, is also limited to *non-preferential* arrangements. Conversely, the FTAs commonly use ROOs on a *preferential basis* and even the Common Declaration (Annex II) does not contain such prohibition. (Coyle 2004) This difference is even magnified by the fact that while the WTO provisions mainly introduce general principles to govern the application of the ROO, ROOs in the RTAs are more detailed. (OECD 2002) This signifies the increasing relevance of ROO in the context of preferential arrangements even if a zero percent MFN tariff rate is agreed upon in the multilateral trade negotiations.

3. Preferential Rules of Origin in Regional or Bilateral FTAs

The proliferation of RTAs has necessarily been accompanied by proliferation of ROO. (Haribal and Beena 2003) Alongside this increase in number is the growing complexity and numerous variations of ROOs are adopted. (See Box 1) This is especially true in the case of a ROO between developed and developing country (although a select few are accorded some sort of special treatment). This is what they call a vertical type FTAs, *North-South* involving on one hand, a rich Northern partner and on the other hand, substantially poorer Southern partner. An examination of the new and emerging RTAs supports this contention.

Box 1. Trends in Regional ROO Regimes

The EU is known to have been designing very touch origin regulations for certain strategic industries to ward off competition from non-member producers. (Haribal and Beena 2003) Nevertheless, the ROO regimes across EU are highly uniform largely due to the European Commission (EC)'s recent drive to harmonize the EU's existing and future preferential ROO regimes in order to facilitate the operations of EU exporters dealing on multiple trade fronts. The harmonization efforts culminated in 1997 in the launch of the Pan-European (PANEURO) system which established identical ROO protocols and product specific ROO across the EU's existing FTAs, providing for diagonal cumulation among participating countries. The PANUERO ROO have since become incorporated in the EU's newer FTAs.

Unlike the EU, there is much more variation across ROO regimes in the America. There's the Latin American Integration Agreement (LAIA) which uses a general rule across the board for all tariff systems (a change in the tariff classification at the heading level or alternatively, a regional value added of at least 50 percent of the FOB export value). On the other hand is the 150-page long NAFTA ROO (which in turn is used as a reference point for US-Mexico and Canada's negotiated FTAs as well as the blue print for the FTAA ROOs)[13] Falling between the two are the Mercusor ROOs and the Central American Common Market, mainly based on

[13] Notably however, US bilateral FTAs with Jordan and Israel diverge markedly from the NAFTA model operating on VC alone while ROO with Singapore, Chile and South Korea features a high degree of selectivity NAFTA-like.

change in heading and different combinations of regional value content and technical requirements, the latter chiefly on change in tariff classifications.

In contrast to the relative complexity of EU and Americas ROOs, Asian FTAs have more general ROOs, the ASEAN Free Trade Area (AFTA)[14], Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA)[15], Singapore-Australia Free Trade Area (SAFTA) as well as the South Pacific Regional Trade and Economic Cooperation (SPARTECA)[16] in the Asia Pacific among others are based on across the board VC rule. Some agreements allow or require the ROO based on import content and most also specify an alternative ROO based on the CTC criterion. Nevertheless, evolving FTAs have engaged in NAFTA or PANEURO like sectoral selectivity regime like that of the Japan-Singapore FTA. (Estevadeordal and Suominen 2003; ADB 2002)

4. Types of Rules of Origin

The criteria adopted in ROOs take a variety of forms. This could be a simple change in tariff classifications to substantial transformation; or requirements for a specified percentage of the commodity's sales price must consist of value added in the partner country; and specification of a percentage of purchased parts and components that must be purchased from the Common Union (CU) or FTA members. (Krueger 1993) In general, there are at least three (3) standards considered by ROO negotiators, namely – *wholly obtained criteria*[17]*, minimal operation criteria*[18] *and substantial transformation criteria*[19].

The traditional substantial transformation rule captures the heart of the meaning of the ROO in a simple, concise way. This term has come to mean the determination of origin based on common law, reasoning from case to case. (Krishna and Krueger 1995) Among its many advantages include flexibility, evolution over time, and development through application to specific facts in an adversarial situation where interested parties are represented. However its disadvantages are inconsistent applications, discretionary nature and the costs of making an origin determination under it. The adoption or rejection of

[14] AFTA's rules of origin allow a good to be considered as originating in a member country (i) if it is wholly produced in a member country or (ii) if the value of the materials from a member country makes up at least 40% of the free on board value and if the final manufacturing process takes place in a member country.

[15] ANZERTA's rules of origin specify that 50% of the factory or works costs of the goods should be made up from expenditure on inputs or contents originating in the area. They impose the additional restriction that the last process of manufacture should have occurred in Australia or New Zealand.

[16] SPARTECA's rules of origin are unusual in that excess local content from some SPARTECA qualifying goods can be transferred from goods with over 70% local content to help otherwise nonqualifying goods (between 35% and 50% local content) to meet the 50% local content requirement.

[17] Applies to goods that are domestically produced only in a specific country.

[18] For simple processing that is negligible in origin determination.

[19] 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 as a method of determining origin depends on which principle one puts more value on: *flexibility* or *certainty*. (La Nasa 1995)

In practice, three main methods are used to determine whether substantial transformation has occurred. The first is the *value-added measure*, which refers to the (minimum) percentage of value added created at the last stage of the production process (also the *domestic content test*)[20]. The second is the *tariff-heading criterion*[21], 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*,[22] which determines, on a case-by-case basis, specific production activities or specific processing 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)

There are other types of test 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) Given that there are no internationally agreed standards, an importing country can vary rules of origin according to its trading partners and products.

Several typical features of preferential ROO can influence whether or not origin is conferred on a product and hence determine the impact of the scheme on trade flows 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 trade policy tool 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

[20] 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)

[21] 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)

[22] 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)

counted as *domestic* for the purposes of determining the origin of the product. (Coyle 2004)

There is a growing trend of the use of the cumulation[23] 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). (see Box 2) (Coyle 2004)

Box 2. US-Singapore FTA: Integrated Sourcing Initiative (ISI)

The ISI, declared to be the "most significant economic aspect[24]" 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 ROO type is now known in the region 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)

- *ROOs in Textiles and Clothing*

It is mainly with respect to sensitive sectors, like textiles and clothing, agricultural and automotive products where the comparison of RTA schemes with the situation that would have prevailed without them leads to concerns of protectionist capture. (OECD

[23] 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)

[24] Statement made by US Ambassador to Singapore Frank Lavin.

2002) Particularly in the case of textiles and clothing, the ROO is especially relevant with the recent 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"[25] 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.

5. Recurring ROO Issues

- *Issue of Spaghetti Bowl Effect*

The technical nature of the ROO is already in itself a difficult concept but the variations of its standards across FTAs (as discussed above) have made it more perplexing. The labyrinthine rules of origin have undeniably made international trade more costly and complex. (WTO 2003)

Precisely it is the number and disparities of ROOs which are the foundation for the argument of *spaghetti bowl effect.* Such overlapping and inconsistency of the ROO systems adopted is relatively important with respect to the issue of trade facilitation. The impact is great among exporters who have different markets abroad, importers of materials for the purpose of re-exporting products, and government administrators of customs.

Administration. Various ROO regimes diverge in their administrative requirements which would entail divergent demands among exporters and importers alike. Usually, a certification serves as a verification of the origin of a given product, hence the type of certification adopted have implication on the facilitation of trade. Some types (as in the case of EU' 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) Again, the difference in the rules adopted by countries entails confusion and more often results on the limitation of potential market depending on its consistency with one's domestic policies.

In the case of administration, another issue aside from cost is the arbitrariness in the process. Verification of origin is generally done at the national level in accordance

[25] *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)

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). (ADB 2002)

On the contrary, there is a greater tendency and more logical for countries engaging in numerous FTAs to adopt uniform rules of origin to protect and promote their country's interests. If this is the case, a more consistent and harmonized rules of origin would eventually evolve for all the preferential and non-preferential purposes. The next and more relevant issue would be what the appropriate model should be. Should the policy be more towards more restrictive or lax ROO rules?

- *Issue of differential impact of restrictive/lax rules*

ROO can either facilitate or restrict trade depending on the adoption of permissive or restrictive rules. ROOs in this regard become more of a trade instrument.

Many commentaries have argued that ROO in the FTAs are themselves hidden protection since ROO are negotiated industry by industry and there is enormous scope for well-organized industries to essentially insulate themselves from the effects of the FTA by devising suitable ROO. (Krishna 2005) In this era of global trade production, rules of origin can serve as an extremely effective means of protectionism in at least two ways:

> "*First*, overly restrictive definitions or applications of preferential rules of origin may deny trade preferences to products that last underwent substantial processing in a favored country or trading area by holding that the product did not originate in the favored country. *Second*, overly liberal definitions and applications of non-preferential ROO will extend country-specific trade restrictive measures to products otherwise exempt from them by holding that the product, even though it last underwent substantial processing in a third country, originated in the disfavored country." (La Nasa 1995)

Level of Restrictiveness. The level of stringency of ROOs may increase due to the following provisions-- 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)

An analysis of the recent FTAs suggests that the restrictiveness of ROOs are more often than not caused by political economy variables that arbitrate the level of tariffs. This has been suggested in the case of developed countries, the EU and the United States. A report of the Australian Productivity Commission found that rules of origin laws under the two Australian FTA with United States and Thailand would be some of the most

restrictive in world trade.[26] Further evidence suggests that agricultural products and textiles and apparels are marked by a particularly high restrictiveness score in each regime. (Estevadeordal and Suominen 2003)

- *Issue of Investment diversion*

Often times, the rules in determining the origin of goods traced among members are important determinant of specialization patterns in preferential trade agreements.

When the rules of origin are more restrictive than necessary to prevent trade deflection, they creates 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 if only to avoid border duties. (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)

6. Framework for ROO Best Practices

In a world where goods are produced from different parts around the world, there is no single correct definition of origin. (La Nasa 1995) And so apart from the harmonization efforts of the WTO, several initiatives have been taken by different regional groupings if only to agree on a system beneficial to all.

Endorsed at the APEC Ministers meeting[27] in Santiago, are the best practices for RTAs/FTAs to help ensure that FTAs and RTAs now under negotiation among APEC Members maximize trade creation and minimize trade distortion, are WTO-consistent and go beyond WTO commitments in certain areas.

Among these best practices is having simple rules of origin that facilitate trade, with the following principles:

- To avoid the possibility of high compliance costs for business, there is a need for ROOs that are easy to understand and to comply with. Wherever possible, an economy's ROOs are consistent across all of its FTAs and RTAs.

- In recognition of the increasingly globalized nature of production and the achievements of APEC in promoting regional economic integration ROOs that maximize trade creation and minimize trade distortion should be adopted.

While it is difficult to derive specific recommendations with regard to the best practice approach to the design of ROO, certain general propositions have been made:

[26] www.news.com.au December 12, 2004.
[27] 16th APEC Ministerial Meeting in Chile, 2004.

(a) The ROO should be simple but precise, transparent and to the extent possible, predictable and stable. The burden most of the time fall particularly heavily upon small and medium sized firms and upon firms of low-income countries.
(b) They should be designed to have the least trade distorting impact and should not become a disguised non-tariff barrier to trade.
(c) As much as possible, the rules should be consistent across products and across agreements. The greater the inconsistencies, the greater the complexity of the system of ROO both for companies and for officials administering the various trade schemes. (Brenton 2003)

It can be observed that these propositions are actually the same as the basic principles enunciated in the WTO ROO Agreement namely, *transparency, predictability, neutrality,* and *non-discrimination*. Since the latter applies to non- preferential ROO, would this mean an adoption of a harmonized ROO for all preferential agreements? This should not necessarily be the case. FTAs/RTAs are required to cover "substantially all-trade" to be WTO consistent, and should result in a more or less similar coverage for all countries engaging in bilateral or regional trade agreements. However, in practice, a country would tend to suit its FTA to serve the different purposes it might have in dealing with its FTA partners. Negotiation itself is mainly politically motivated and so the coverage of each trade agreement is expected to be different and the rules to govern also varies. As much as there is the need for simplicity and flexibility, the efficacy of these rules against rent-seekers should not be compromised.

- ***Simplicity vs Efficacy***

There is a consensus that the movement should be towards more simple and unrestrictive ROO. Ideally, ROO should as far as possible be neutral in their impacts on trade flows. (Scollay 2003) Simpler ROO will help promote regional trade and international competitiveness of member states.

This is also of particular relevance in compliance with 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)

- ***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. Otherwise, it will entail unnecessary waste of time and opportunity losses.

On the other hand, there should be some sort of safety nets or safeguards against the 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. This is because the consequent uncertainty regarding ROO would add to the burden of negotiators from developing countries. (Haribal and Beena 2003)

- ***Accumulation Rule***

Mechanisms have been provided to curve the problem of protectionist tendency in the ROO, which gave rise to the inclusion of cumulation or accumulation rule in most FTAs. Cumulation provides a certain degree of flexibility among the producers as to sources of their inputs but as to what extent should this 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? Again, negotiators should look at the national interests of their states and balance them with their commitments in other arrangements, be it multilateral or preferential. 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.

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)

Finally, the treatment of duty drawback and of outward processing outside the free trade or preferential trade partners may also be considered. (Brenton 2003)

- ***Business Model Driven***

Rules of origin are bound to be affected by the business models that tend to evolve over time. As such, the type of ROO to use should be examined in the context of the business model, with the end in view of not only reducing obstacles to trade and growth but , but rather creating a business opportunity.[28] As discussed earlier, simple and flexible ROO will help business and industries achieve economies of scale. Ideally, this should be beneficial to both multinationals and small and medium enterprises (SMEs). It is important to note however, that realistically, the pressure on the model of ROO would come strongly from those MNCs which has established their base in different locations, making up their global production networks (GPNs). Governments would need to take this into account if only to become an active player in the GPNs. At the same time, governments need to consider the conflicting demands coming from the need to promote their internationally competitive industries and the pressures for protection from domestically-focused industries.

International production networks promote a new pattern of trade, such that goods travel across several locations before reaching final consumers, and the total value of trade recorded in such products exceeds their value added by a considerable margin. Consequently, trade in such products can grow without a commensurate increase in their final consumption as production networks are extended across space. The increased import content of exports has heightened the importance of the rules applied to determine the origin of traded goods. (UNCTAD 2002)

[28] Commentary of a Philippine government official.

ROO thus have a significant impact on the strategic planning of profit-maximizing firms. The combination of bookkeeping costs with ROO-induced constraints on international sourcing can be particularly penalizing for companies operating in globally integrated supply chains. (Cadot et al 2002)

The importance of these GPNs has been well-recognized and some agreements have been made to encourage and promote their development. Take for instance the ASEAN Industrial Cooperation Scheme (AICO) which encourages technology investments in the ASEAN area by reducing tariffs on goods produced by companies that are partially owned by ASEAN citizens (30% equity), incorporated, and operating in member countries and cooperating or sharing resources (such as sharing technology or consolidating raw materials purchases) with another company in the region. (ADB 2002) ROO should at least be supportive of the expansion and development of these initiatives.

Going back to the business-model driven proposal, necessary caution is to be made. There must be a delineation between business opportunity and business protection. Business lobbies being relatively powerful in most of the countries (especially developed ones), are likely to exploit the rules of origin and sectoral exceptions in these arrangements in ways that will maximize trade diversion and minimize trade creation. (Panagariya 2000)

For example, the US-Singapore FTA ISI has been criticized as far more than a means of cutting red tape or promoting economic efficiency but rather more of a tool used both to further the geostrategic goals of the states involved in the negotiations and to advance the interests of certain groups within the states. (Coyle 2004) In the case of NAFTA, specifically on Chapter 4 which deals exclusively with automotive goods, its purpose seems more explicit and detailed than other goods. Some would claim that the text was drafted by a group that included at least one economist who was an employee of a US auto company, and the purpose of draft rules was to permit his company to export tariff free from Mexico to US while preventing Japanese competitors from doing the same. (Deardorff 2004)

- ***Harmonization of Customs Procedure***

There have been efforts for worldwide as well as region-wide harmonization of tariff nomenclature. This is relatively important because different origin determinations for the firms often resulting in inconsistencies which sometimes appear to have been manipulated to achieve trade restrictive results. (La Nasa 1995) Recently, the WCO came up with a Framework of Standards to Secure and Facilitate Global Trade.

Harmonization of ROO standards also requires the streamlining of customs procedures and simplification of customs clearances including the introduction of paperless trading in many FTAs. 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 this is non-discriminatory in nature is another thing. From the point of view of a developing country, the latter is more important. (Harilal and Beena 2003)

Any developmental purpose needs a human face. For the proposed business-driven model, this human face could be the inclusion of a developing country dimension. Arguments against free trade, competition policy and the like are a result of lack of safety nets for those who are not prepared to participate and more so compete.

Take for example the promotion of GPNs, developing countries need them to support and promote their local industries. The development of the GPNs should not be the end-all and be-all of the business-driven model. On the contrary, it should be geared towards the preparation, development, and internationalization of SMEs. ROO thus, as a trade instrument becomes a conduit of free trade.

The ideal ROO therefore is that which would promote development (or development friendly) and with a developing country dimension. (See example in Box 3) Needless to say, capacity building is crucial, which should be extended for all the exporters, importers and administrators if we are to achieve the best practices in the rules of origin.

Box 3. Development-Friendly ROO

The EC eyes replacing current rules with a single value-added method for determining origin which would make them clearer as well as more development-friendly. The changes envisaged will not happen overnight but will be introduced over time, beginning with priority arrangements such as GSP. The Commission's Communication sets out the following plans:

- A single across-the-board criterion for determining the origin of non-wholly-obtained goods based, subject to further impact assessment, on a certain threshold of value-added (which would be fixed on the basis of a sound economic analysis and according to the objectives of the particular preferential arrangements to the required degree of trade liberalization) in the beneficiary country or regional group concerns;
- A rebalancing of the rights and obligations of operators and administrations. The current system of proving origin by means of a certificate signed by the exporter and stamped by competent authorities would be replaced by a statement of origin by registered exporters;
- The development of instruments to ensure that the beneficiary countries comply with their obligations. This would include measures to improve evaluation, information flows, training and technical assistance so as to assist co-operation between the Community and its preferential partners, as well as a system for the periodic monitoring of compliance.

Source: various EC Memos March 2005

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