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Towards Convergence on Rules of Origin Between Trade at the Regional and Multilateral Level

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Think Piece

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Abbreviations and Acronyms

ACP	African, Caribbean, and Pacific Group of States
ARO	Agreement on Rules of Origin
ASEAN	Association of Southeast Asian Nations
CETA	Canada-EU Comprehensive Economic and Trade Agreement
COMESA	Common Market for Eastern and Southern Africa
CRO	Committee on Rules of Origin
CTC	change of tariff classification
CUSTA	Canada-US Trade Agreement
EFTA	European Free Trade Association
EU	European Union
EUI	European University Institute
FTA	free trade agreement
GSP	Generalized System of Preferences
GVC	global value chain
HRO	harmonized rules of origin
HS	Harmonized System
HWP	Harmonization Work Programme
ITA	Information Technology Agreement
LDC	least-developed country
MERCOSUR	Southern Common Market
MFN	most-favoured nation
NAFTA	North American Free Trade Agreement
RoO	rules of origin
RTA	regional trade agreement
SADC	Southern African Development Community
TCRO	Technical Committee on Rules of Origin
TPP	Trans-Pacific Partnership
UNCTAD	United Nations Conference on Trade and Development
US	United States
WTO	World Trade Organization

Abstract

The ongoing stalemate on the Harmonization Work Programme (HWP) with respect to non-preferential rules of origin (RoO) has left business trade negotiators and customs officials negotiating free trade agreements (FTAs) in a "no man's land." Progress is clearly needed to ensure trade facilitation, not only for least-developed countries (LDCs), but all states in the period ahead. This paper examines some of the current limitations on RoO and the causes of deadlock. It also reviews lessons learned thus far in the implementation of RoO to put forward recommendations concerning cumulation, administration, and the need to take into account services in the manufacturing process.

1. The Issues at Stake

The absence of clear multilateral disciplines on rules of origin (RoO) leaves business trade negotiators and customs officials negotiating free trade agreements (FTAs) in a "no man's land."

The Harmonization Work Programme (HWP) on non-preferential RoO carried out under the Agreement on Rules of Origin (ARO) should have been completed in 1999. Despite considerable progress, as witnessed by the existence of the draft text, a final consensus is lacking. The lack of consensus is mainly due to the opposition of some World Trade Organization (WTO) members, led by the United States (US), to the implications of the results of the HWP on other WTO agreements — the so-called implications issue.

As a result, since 2007, there have not been formal negotiations, and discussions have been limited to updating the draft text in a new version of the Harmonized System (HS) and to "educational exercises," meaning informal workshops on the implications of the absence of harmonised RoO for business.

Despite this stalemate in making progress on non-preferential RoO, negotiations on preferential RoO have been thriving, given the flourishing of regional trade agreements (RTAs).

The main tenet of RoO experts and trade officials is there are no possible spillovers among preferential and non-preferential RoO, since they serve different trade policy objectives. Preferential RoO serve to determine whether a preferential tariff is applicable under a RTA or a unilateral arrangement, while non-preferential RoO serve to determine the application of a most-favoured nation (MFN) tariff or other WTO agreement, according to the ARO.

This assertion is completely valid, according to the tradition of maintaining a rigid separation of the two RoO worlds: preferential and non-preferential.

However, from the time the US entered the North American Free Trade Agreement (NAFTA) and the European Union (EU) further developed its network of RTAs, there have been considerable evolutions in the technique and content of drafting RoO. South-South FTAs — the Southern African Development Community (SADC); the Common Market for Eastern and Southern Africa (COMESA); Southern Common Market (MERCOSUR); and the Association of Southeast Asian Nations (ASEAN) — traditionally adopted the simplest formula, such as an across-the-board percentage criterion mirroring and the percentage rules in the US Generalized System of Preferences (GSP) scheme. Also, they provide, as an alternative rule, a change of tariff heading criterion according to the EU model. In short, these RTAs have been unable to develop their own RoO model. In the worst cases, after having negotiated FTAs comprising stringent RoO with partners in the North, some countries have then forced these rules upon their regional partners in the South.

Despite the claimed rigid separation between non-preferential and preferential RoO, the borders have been porous since day one. It is obvious that NAFTA had a tremendous influence on the way the ARO was designed. It was upon US insistence that the ARO recognises the change of tariff classification (CTC) as the preferred methodology for drafting rules for non-preferential RoO, as in the case of NAFTA while the EU traditionally adopted a combination of criteria, such as the CTC, ad valorem and specific working and processing. By itself this could be interpreted as a first sign of convergence, even if there are different modalities in drafting RoO according to the CTC criterion.

This primacy of the use of CTC over other methodologies for determining substantial transformation, namely ad valorem percentage criterion and specific working and processing later, caused some differences during the initial phases of the HWP negotiations among the EU and NAFTA partners that took place in the Technical Committee on Rules of Origin (TCRO) and later in the WTO Committee on Rules of Origin (CRO).

In fact, the 1996 - 1999 TCRO negotiations on non-preferential RoO was the first time the tectonic system of 20-plus years of dealing with RoO in the EU with European Free Trade Association (EFTA) members and the African, Caribbean, and Pacific Group of States (ACP) partners were confronted with the newly matured experience of the US and its partners in negotiating the Canada-US Trade Agreement (CUSTA) and NAFTA.

While none of the negotiators in the TCRO at that time would have admitted that preferential RoO had a bearing on the HWP, it was clear, as demonstrated by the dynamic of the negotiations, that the negotiations on non-preferential RoO started from a preferential RoO background at least at the technical level. In other words, each one proposed and defended its own model of RoO.

The actual text of the HWP is the result of a compromise among the EU and NAFTA models, with notable innovations and some disagreement on specific sectors, like machinery. The "machinery package" allowed each member to choose either a "change of tariff classification rule" — the preferred US way for origin determination — or a "value-added rule" — the preferred EU way for determining origin in this specific sector and circumstance[1] (the so-called dual-rule approach).[2]

In retrospect, the draft harmonized rules of origin (HRO) text represents a tangible sign of convergence that, even if not agreed, had its own influence on the way RoO were negotiated in subsequent FTAs. Among others, one may quote the progressive acceptance of the use of the wholly obtained criterion as a requirement for the list of product-specific rules (a typical EU feature) in the EU-Mexico FTA and later the Canada-EU Comprehensive Economic and Trade Agreement (CETA), or the use of chemical reaction, a concept inherited from the HWP work, as a specific requirement for some chemical products given the inherent technical difficulty of determining the corresponding CTC for chemical products.

In 2007, the work on HWP, in terms of negotiations and substantive progress on the RoO, came to a stop in light of insurmountable differences among members on the "implication issue." However, thanks to the flourishing of FTAs, RoO have been on the top of the negotiating agenda of the majority of WTO members ever since. The EU also made substantial changes to its RoO model. First, it progressively abandoned the kind of "straight jacket" model that it imposed upon itself with the Pan-European RoO. Second, it introduced a sweeping and unprecedented reform of unilateral RoO, especially for least-developed countries (LDCs), that — albeit stated as limited to this kind of arrangement — could be regarded as a way forward for the future RoO of the EU.

The development in preferential RoO in FTAs of major players are all leading to simplification and streamlining of the RoO led by the numerous lessons learned of now more than 20 years of operations of major FTAs. This is also shown by the relatively high utilisation rate recorded by major FTAs, ranging from 80 percent to 90 percent. In a nutshell, there has been a lot of work on RoO that has paid off, even if business is still complaining about the excessive costs of managing RoO. Most recently (2013-2015), the debate over the preferential RoO for LDCs has brought new life to the discussions in the CRO, leading to two Ministerial Decisions. This is a tangible sign that progress can be made even at the multilateral level. The question now is how to resume work at the multilateral level using the progress and lessons learned on RoO with respect to either preferential or non-preferential.

[1] See WTO G/RO/W/148 challenges faced by LDCs in complying with preferential rules of origin under unilateral preference schemes of 28 October 2014

[2] See WTO document JOB(07)/73)

2. What You Need to Acknowledge to Move Ahead

As a fundamental premise for progress on the issue of RoO, there is a series of important lessons that have to be learned by the international community, including firms and customs and trade officials. These lessons from the overall experiences in the HWP and more than 20 years of negotiating RoO in RTAs are summarised below.

First, it is necessary to introduce a distinction between the desired objectives of a given set of RoO from the drafting methodology. A distinction has to be made between the "form" of a given RoO and its "substance."

The "substance" is the degree of restrictiveness of RoO with respect to an existing value chain in which it is expected to operate. Why is such a distinction important? If you agree on the substance of RoO, it is easier to agree to a convergence, since the form of RoO is usually a matter of drafting methodology.

The "form" is the way the RoO are written using different methodologies, namely a CTC at the heading level, the subheading level with or without exception, and the percentage criterion or specific working or processing and their variants.

Second, as argued by the LDCs in their submissions to the WTO, there has been a convergence on the methodology to draft the ad valorem percentage criterion. Both the EU and the US, as well as their main counterparts, like Japan, South Korea, Australia, and New Zealand have progressively abandoned a methodology based on the calculations of value added by addition to calculations based on a value of material. Some innovations have also been introduced, such as the deduction of the addition of cost of freight and insurance under the majority of the most recent US FTAs, including the Trans-Pacific Partnership (TPP). There are, of course, differences in the arithmetical calculations and the definition of numerator and denominator. However, there is real convergence on the concept of calculating the ad valorem percentage based on a value of materials calculation rather than a value added or net cost approach, as used in NAFTA for automotive products. This tendency is confirmed by the evolution of the use of the net cost method in US FTAs that has been gradually introduced in subsequent FTAs, and the introduction of the build-up and build-down method that has replaced the transaction value of NAFTA as shown in Table 1.

Finally, there is an increased tendency, with the notable exception of sensitive sectors, like textiles and clothing for the US, processed agricultural products in the EU and Japan, and metal products and some machinery to adhere to the concept of single transformation, in whatever form it may be expressed.

The sceptics and the old timers will continue to argue that such a simple rule of thumb is unthinkable. Yet, looking at the issue of convergence with a fresh eye shows a subtle thread that in a number of sectors is bringing together all the actors (firms and customs and trade officials) to such a convergence. It may be that these sectors are MFN free, because of the Information Technology Agreement (ITA) or other MFN agreements on chemical products. However, there are other sectors where there is convergence, the MFN duty is positive and the product is sensitive, as in the case of bicycles shown in Table 2.

Table 1.

Evolution of the NAFTA percentage-based RoO*

Regional Value Content	NAFTA	CHL-USA	CAFTA	USA-SIN	USA-AUS	USA-KOR	TPP
No. of PSRO	1,125	1,043	1,017	2,974	965	758	1,245
Net cost	323	0	6	0	0	6	22
Transaction	248	0	0	0	0	0	0
Build-up	0	164	146	239	148	147	398
Build-down	0	157	147	213	144	152	457

*Calculations made by the author.

3. Way Forward

The "spell" over the lack of progress and meaningful discussions on RoO at the multilateral level should be broken. The de facto convergence among preferential and non-preferential RoO in some sectors should be brought to light at the multilateral level. Ongoing research by the United Nations Conference on Trade and Development (UNCTAD) and the European University Institute (EUI) is aimed at clearly identifying such convergence in some sectors as well as the divergence in some sensitive sectors, like clothing and processed agricultural products. Some early examples are shown in Table 2.

Single transformation should be the rule of thumb for drafting RoO according to global value chains (GVCs). GVCs are operating on a series of single transformations performed in different countries. The design of RoO should reflect this reality. Double or triple transformation requirements may remain in some sectors, owing to the sensitivities, but should not impede progress in remaining sectors representing a significant amount of world trade.

The ongoing discussion at the CRO on preferential RoO for LDCs is a unique opportunity to bring new life to multilateral discussion on RoO at the WTO. These discussions should be informed by the lessons learned on RoO mentioned above. The LDCs should aim at achieving progress in the CRO debates on the concept of single transformation, rather than insisting on binding language in ministerial decisions. Some clear principles, like the adoption of a value of materials and the deduction of the cost of freight and insurance, have been established.

However, much remains to be done on the use of CTC and working on processing requirements for a better understanding of the principle of single transformation applying across the board,

indistinctly from the methodology used to define substantial transformation. Other issues also have to be clarified as follows:

3.1. Cumulation

Cumulation is no substitute for liberal RoO. With liberal RoO, producers may source their inputs worldwide from the most competitive producer at the best price according to GVCs.

Cumulation is often branded as a tool to promote regional integration. Experience has shown that this is overrated. Over the past 30 years, cumulation under the previous versions of the Lomé and Cotonou agreements has not helped regional integration in Africa and the ACP countries. Cumulation worked in the ASEAN context, but it has also clearly shown its limitations.

Extended cumulation with preference-giving countries that are members of mega-regional FTAs or subregional networks of FTAs is the kind of cumulation the LDCs have to seek.

3.2. Administration

Administrative aspects of RoO are a significant cost for customs to administer and for the private sector to follow. These administrative costs are at times the main hurdle for RoO, and little attention has been devoted to this aspect.

Overreliance by some customs administrations on archaic forms of administering RoO based on documentary evidence, i.e., a certificate of origin, the exchange of seals and signatures of certifying officers, or non-manipulation certificates issued in the country of transit, has mostly turned this type of administration of RoO into a non-tariff barrier and is the opposite of trade facilitation.

The new trend is, at the very least, to abandon the requirement to exchange signatures that still exist in some major FTAs and to rely progressively on a customs-authorised exporter declaration of origin. Retroactive checks and post-clearance recovery accompany this method of administering RoO.

In 2017, the EU reform of RoO will introduce, under the GSP rules, listing of registered exporters in a database administered by national customs agencies. The registered exporter will be given a number and may issue a declaration of origin. When this declaration is presented at an EU port of entry, customs will consult the joint database to ascertain whether the exporter has been registered and, if so, will grant preferential tariff rates. Verification of an exporter's declaration and post-clearance recovery are part of this administrative method.

However, there are other methods of administering RoO, such as the method employed by US Customs and Border Protection, which is based entirely on the importer declaration and disregards evidence provided by exporters or certificates of origin issued by third parties. Whatever method is used, it is clear that reliance on certificates of origin and the exchange of seals and signatures should be a thing of the past.

3.3. WTO Stalemate

A comprehensive analysis of the stalemate that emerged in the WTO on the adoption of HRO and the different positions taken by the major players is contained in Inama.[3] Most negotiators see the main source of the deadlock not so much as an inability to agree on a common approach per se, but an unwillingness by some parts of government to be constrained in the application of RoO. That is, the problem is not a technical disagreement on what makes sense.

[3] Inama, Stefano. 2009. Rules of Origin in International Trade. New York: Cambridge University Press

The problem may be a desire by some government agencies not to be required to use the same rule for all trade policy purposes, especially trade defence instruments. In this context, it should be explored whether these concerns may be addressed by the discussions on anti-circumvention of trade defence measures that could be revived in the WTO to unlock meaningful discussion in the CRO.

3.4. Manufacturing vs. Services

The current RoO, centred on manufacturing processes as origin-conferring operations with the exclusion of the service component, no longer reflect business realities or the core economic activities that have entered into the production of the good. The celebrated example of the iPhone is a telling story. The international community should develop a second generation of RoO, taking into account the services component. The UNCTAD/EUI research is covering this aspect.

Table 2.

Convergence and Divergence in RoO

HS Code	HRO	CETA	TPP	EU-KOR	US-KOR
16.04 Prepared or preserved fish; caviar and caviar substitutes prepared from fish eggs	CTH	A change from any other chapter, except from Chapter 3	A change to a good of heading 16.05 from any other chapter	Manufacture: -for animals of Chapter 1, and/or -in which all the materia1s of Chapter 3 used are wholly obtained	A change to heading 16.05 from any other chapter
28.50 Hydrides, nitrides, azides, silicides and borides, whether or not chemically defined, other than compounds which are also carbides of heading 28.49.	CTH	A change from any other subheading, or: A change from within any one of these subheadings, whether or not there is also a change from any other subheading, provided that the value of non-originating materials classified in the same subheading as the final product does not exceed 20 per cent of the transaction value or ex-works price of the product.	A change to a good of heading 28.50 from any other heading.	Manufacture from materials of any heading, except that of the product. However, materials of the same heading as the product may be used, provided that their total value does not exceed 20 % of the ex-works price of the product	A change to heading 28.10 through 28.53 from any other heading
87.12 Bicycles and other cycles (including delivery tricycles), not motorized	CTH, except from heading 87.14; or 35% value added rule	A change from any other heading, except from 87.14; or A change from heading 87.14, whether or not there is also a change from any other heading, provided that the value of non-originating materials of heading 87.14 does not exceed 50 per cent of the transaction value or ex-works price of the product	A change to a good of heading 87.12 from any other heading, except from heading 87.14; or No change in tariff classification required for a good of heading 87.12, provided there is a regional value content of not less than: a) 35 per cent under the build-up method; or b) 45 per cent under the build-down method; or c) 60 per cent under the focused value method taking into account only the non- originating materials of heading 87.12 and 87.14	Manufacture in which the value of all the materials used does not exceed 45% of the ex-works price of the product	A change to heading 87.11 through 87.13 from any other heading, except from heading

Jointly implemented by the International Centre for Trade and Sustainable Development (ICTSD) and the Inter-American Development Bank (IDB), the RTA Exchange works in the interest of the sharing of ideas, experiences to date and best practices to harvest innovation from RTAs and leverage lessons learned towards progress at the multilateral level. Conceived in the context of the E15 Initiative, the RTA Exchange creates a space where stakeholders can access the collective international knowledge on RTAs and engage in dialogue on RTA-related policy issues.