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Brexit and Origin: A Case for the Wider Use of Cross-Cumulation

Anna Jerzewska

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Think Piece



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Inter-American Development Bank (IDB)
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Anna Jerzewska is a free trade agreements specialist working as a global trade and customs consultant in the private sector. For further details and other publications please see her website www.freetradeagreements.co.uk. Anna is a participant in the RTA Exchange platform.

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List of Abbreviations

ASEAN	Association of Southeast Asian Nations
EU	European Union
FTA	free trade agreement
GSP	Generalised Scheme of Preferences
NAFTA	North American Free Trade Agreement
UK	United Kingdom
US	United States
WTO	World Trade Organization

Abstract

As the United Kingdom negotiates its exit from the European Union, rules of origin are becoming a key topic. Whatever form the future UK-EU trade relationship will take, the question of determining the origin of products will need to be addressed. This paper examines cross-cumulation and ways it could be applied after Brexit to mitigate the impact of rules of origin requirements. It argues that, in the post-Brexit environment, cross-cumulation could support the UK's participation in global value chains by introducing more flexible origin provisions and expanding free trade agreement origin zones.

1. Brexit and Origin

As the United Kingdom (UK) negotiates its exit from the European Union (EU), rules of origin are becoming a key topic. How will the exit from the single market impact the current production patterns in Europe in industries where hundreds of parts move across national borders every day? How will origin be dealt with in what is promising to be a unique and bespoke trade relationship with the EU? What type of rules of origin should the UK seek in its future trade agreements?

One of the ways to address the question of origin would be to introduce a more flexible approach and to allow the addition (“cumulation”) of origin from multiple locations. Different types of such provisions, known as cumulation, have already been applied in various trade agreements. This paper examines how a less common type of cumulation could be applied after Brexit to mitigate the impact of origin requirements. Thanks to its unique features, namely the fact that it can be limited to a specific type of goods, cross-cumulation is increasingly being applied in trade agreements around the world.

Origin, understood as the “economic nationality” of the product, determines whether the good is eligible for a reduced rate of import duties under a trade agreement. It is determined according to complex rules of origin and origin provisions. Rules of origin differ under every trade agreement, adding to the regulatory complexity of the dense network of coexisting trade agreements.

Whatever form the future UK-EU trade relationship will take, the question of determining the origin of products will need to be addressed. The two scenarios where the issue of origin would have been dealt with without the need to establish elaborate rules of origin — the single market and a customs union — seem to have been ruled out. Any other option, whether a comprehensive trade agreement resembling the Canada-EU deal or a highly bespoke arrangement,

will require a full set of rules of origin between the UK and the EU.

In addition, when the UK leaves the EU, it will cease to have access to the current network of the EU’s free trade agreements (FTAs), which allow most goods to be traded between the EU and other parties under reduced or nil customs duty rates.

The UK will seek to secure its own deals. In fact, it is currently in the process of conducting initial discussions with prospective FTA partners, and it has expressed the intention of signing “quick” deals with a number of countries after Brexit. Yet, even if the UK reaches a deal with the EU, renegotiates agreements with the EU’s existing partners, such as Canada, Japan or South Korea, or signs deals with new partners, such as the United States (US) or India, the question of origin would remain.

2. Why Will Origin be Critical for Brexit?

When negotiating a deal with the EU, the UK will need to decide whether to stay in the Pan-Euro-Mediterranean agreement, which allows the cumulation of origin among a number of countries in Europe and North Africa but requires all countries to be joined by a trade agreement with identical rules of origin, or whether to negotiate new rules.

The UK will face a similar decision when negotiating with the current EU FTA partners, such as Canada or Mexico: whether to keep the rules of origin from the EU agreements or negotiate new ones. A set of rules of origin will also need to be implemented in any agreement the UK signs with new trade partners. This will most likely lead to a dense network of overlapping rules with which UK companies will need to comply, many of which have not traded under preference before.

While within an FTA originating goods can be used in the production process freely, the situation becomes

more complicated when two or more agreements are involved. Goods originating under one agreement are not necessarily considered originating under other agreements.

In practice, this means that post-Brexit, UK producers will no longer be able to include EU inputs or processing when determining origin for exports to other countries under a trade agreement. This will be the case even when both the EU and the UK are joined by an FTA with the same country — for example when the UK negotiates its own agreement with Canada.

Given the high level of integration between the two economies, this will have a significant impact. If producers cannot meet the rules of origin, they will not be able to trade under preference. As customs duties are non-recoverable, this will represent a direct cost. Cross-cumulation could help to address this and a number of other origin-related issues.

3. What is Cumulation and How Does Cross-Cumulation Differ?

Cumulation of origin is one of the ways to allow greater flexibility when it comes to using raw and semi-manufactured materials in the production process. It allows a member of a trade agreement to use inputs from other members and move stages of production while maintaining the originating status. Types of cumulation vary depending on the number of parties involved and the types of inputs allowed. While cumulation of originating content between members is a feature of all free trade agreements, other types of cumulation are less common. In all cases, cumulation of origin requires two conditions to be fulfilled:

- All participating countries need to be linked by a trade agreement; and
- The rules of origin under these agreements need to be identical.

Both of these conditions can pose a challenge. Negotiating a comprehensive trade agreement can take a number of years, and rules of origin are often only a small part of such negotiations. Introducing identical rules of origin across different trade agreements can also be counterproductive as they reflect the political and economic realities of the signatory countries.

Cross-cumulation, also known as third-party or expanded cumulation, allows the cumulation of origin between three or more countries which are not necessarily joined by a trade agreement or are joined by agreements with disparate rules of origin.

For example, cross-cumulation is applied between countries A and B and B and C, which are linked by trade agreements. Under this scenario, in the absence of cross-cumulation, inputs originating in country A used in the production process in country B (notwithstanding the absorption provisions) cannot be counted towards originating status of the product exported to country C under the B-C trade agreements and corresponding rules of origin. As such, the producer in country B is required to fulfil the rule of origin under the B-C trade agreement solely based on the input and processing taking place in country B.

With cross-cumulation, originating inputs from country A can be counted towards the originating status of goods produced in country B when they are exported to country C even when the rules of origin under the A-B and B-C trade agreements differ. In other words, production in country A can be counted towards determining whether the rule of origin is met under the B-C agreement.

In addition, unlike standard cumulation, cross-cumulation can be applied even when countries A and C are not linked by a trade agreement of their own. In such cases, neither of the two conditions of standard cumulation is fulfilled.

4. Examples of Cross-Cumulation under Various Trade Agreements

To date, cross-cumulation has been used in a number of agreements worldwide. For example, under the Canada-Colombia and Canada-Peru trade agreements, various materials originating in the US can be used in the production of passenger vehicles while maintaining originating status, provided these goods would be originating if the US were part of the Canada-Peru FTA (i.e., provided they fulfil rules of origin under this agreement).

Both agreements also allow for the use of nylon filament yarn from the US and Mexico to be considered as an originating material, provided it would be considered originating if the US and Mexico were part of the agreement (i.e., they fulfil the rule of origin under the respective agreement). Imports of nylon from non-parties are also possible under the Colombia-US trade agreement (available for inputs from Canada, Mexico, and Israel). The text of the Colombia-US agreement goes further to recommend that parties should enter into discussions on expanding cross-cumulation in the textile and apparel sector to other countries in the region.

The EU-Vietnam trade agreement includes cross-cumulation provisions on cuttlefish and squid with Association of Southeast Asian Nations (ASEAN) member states and on fabrics originating in South Korea.

Under EU customs legislation, the Union Customs Code, cross-cumulation for certain goods can be permitted under the Generalised Scheme of Preferences (GSP) programme for third-party countries with which the EU has a trade agreement in place. Under this provision, subject to the EU Commission's decision, materials from a third-party country could be used for further processing or be incorporated in products manufactured in a GSP

beneficiary country provided they fulfil the rules of origin under the agreement that the third-party country has with the EU. In other words, the materials can be counted as originating when used in a GSP country if they would be considered originating when exported directly to the EU under the bilateral trade agreement with that country.

In all the above examples, cross-cumulation has been applied to only a selection of traded goods. However, in future agreements, it could easily be extended to entire sectors. It could also be introduced under a number of existing agreements, as many of them already include provisions on cross-cumulation which could be "activated." For example, many Canadian FTAs, including the Canada-EU agreement, have a clause which states that, where both parties have a trade agreement with the same non-party, the goods originating from that non-party can be treated as originating in the parties of the agreement subject to confirmation by all of the parties. A further example is the newly concluded EU-Japan agreement, which includes an enabling clause for cross-cumulation of origin for passenger cars with countries with which both parties have a trade agreement in place.

5. Key Benefits of Cross-Cumulation in Practice

Cross-cumulation is slowly becoming a staple of many newer trade agreements. This is mainly due to its specific characteristics which allow the widening of the FTA "origin zone" to other countries in a controlled way with limited risk. Cross-cumulation could be viewed as a step between strict and flexible rules of origin. Strict rules of origin limit companies' sourcing options. Flexible rules of origin grant access to a wider range of inputs from non-FTA parties but can lead to trans-shipment from third-party countries.

5.1. Cross-Cumulation Can be Customised under Each Agreement and Applied to a Limited Number of Products

One of the key advantages of cross-cumulation is that it allows for much greater flexibility. It can be applied in cases where all participating countries are not connected by a trade agreement or are connected by trade agreements with disparate sets of rules of origin. It can be applied on a unilateral basis or be fully reciprocal. It can also be applied to a limited number of products. For example, within one agreement it can be applied to a couple of tariff lines with one non-party and a couple of different tariff lines with another non-party.

In short, while negotiating an FTA with cross-cumulation provisions, parties can decide how, with which non-party and to what type of products it will apply. As such, the provision is highly customisable and can be applied in a number of ways.

5.2. Under Cross-Cumulation, Materials from a Non-Party Still Need to Comply with Rules of Origin

The main purpose of rules of origin is to prevent trans-shipment: a situation where third countries enjoy the benefits of a trade agreement without offering reciprocal market access. While cross-cumulation may appear to remove this obligation, the traded goods are in fact still required to comply with rules of origin.

From a practical perspective, there are different options when it comes to which set of rules of origin the goods should comply with. This in turn dictates the documentary evidence that is required to demonstrate origin and to allow the goods to move between countries A, B, and C.

In the above example with countries A, B, and C, materials obtained in country A comply with rules of origin when imported from B to C in one of two ways. If there is an FTA in place between countries A and C, they are considered originating if they would be originating when imported directly from A to C under A-C FTA rules of origin. The second option is when countries A and C are not linked by a trade agreement. In such a scenario, goods originating in country A are considered originating if they fulfil the rules of the B-C agreement.

Cross-cumulation will have the biggest impact in cases where a local content rule of origin is applied. However, it will also facilitate trade for goods subject to other types of rules of origin.

5.3. Cross-Cumulation Acts as a De Facto Extension of the Market Access Provisions under an FTA and is a Way to Multilateralise the Agreement

Cross-cumulation introduces more flexibility in terms of the choice of supplier by extending the originating status for particular goods to selected countries. In the aforementioned example with countries A, B, and C, cross-cumulation could also be applied if countries A and C were not joined by an FTA. Negotiating a comprehensive trade agreement is a complex process. The level of market access is often subject to intense negotiations in industries considered sensitive. However, when trade negotiations were delayed in recent years, it was often for reasons not related to tariffs and market access (investment protection or product standards).

Cross-cumulation expands the FTA zone for the purpose of determining the origin of goods. As such, it allows for the extension of certain economic benefits of an FTA without having to negotiate a full trade agreement which can take several years. It allows for the multilateralisation of existing agreements and cuts through the “spaghetti bowl” of overlapping rules.

The efforts to harmonise rules of origin across agreements have brought few results. Cross-cumulation is an alternative approach and could be viewed as an attempt to introduce a “mutual recognition” of origin rules. Similar principles have been applied in other areas of international trade, such as the World Trade Organization (WTO) Technical Barriers to Trade Agreement. The concept of equivalence ensures that WTO members treat other members’ regulations in this area as equivalent to their own, provided they fulfil the same objectives and offer an equivalent level of protection. Similarly, rules of origin under a different agreement could be considered as providing an equal level of protection for the domestic market.

5.4. Cross-Cumulation Can Support Integrated Supply Chains

In the Canada-Colombia and Canada-Peru trade agreements, cross-cumulation for passenger vehicle parts has been applied to support the highly integrated automotive industry of countries in the North American Free Trade Agreement (NAFTA). The EU and UK economies have an equally high level of integration in a number of sectors, and parts and components in these sectors cross borders often. To support its exports in these sectors, the UK could decide to apply cross-cumulation with the EU in its negotiations with new FTA partners. The EU could also include cross-cumulation provisions with the UK in their respective FTAs for certain sectors in which the two economies are particularly integrated. For some sectors, cross-cumulation between the EU and the UK could also be potentially useful.

6. Cross-Cumulation and Brexit

In the post-Brexit trading model, cross-cumulation could support the UK’s participation in global value chains by introducing more flexible origin provisions and expanding FTA origin zones. It could be applied gradually to certain sectors or goods. It could also be applied either unilaterally or with full reciprocity. Given the small risk of trans-shipment and the ability to apply cross-cumulation to a limited number of products, the provision could easily be implemented and tested.

It could also be used as a temporary measure during the transitional period while the UK negotiates its own trade agreements with current EU partners. For example, the EU and Canada could agree to apply cross-cumulation on UK inputs while the UK negotiates a new agreement with Canada. This would only address part of the problem, as UK producers would still not be able to export or import from Canada under preference. However, UK inputs could continue to be used by EU producers. Cross-cumulation could also be applied on a fully reciprocal basis between Canada, the EU and the UK once a Canada-UK deal has been negotiated.

In preparation for prospective trade negotiations, economic analysis of which sectors or product lines would benefit most from cross-cumulation could be conducted. Cross-cumulation may not be advisable for all sectors for a number of reasons, including competitive advantage and protecting certain domestic industries. Further analysis would enable the identification of the sectors where cross-cumulation should be considered. The provision could also be introduced into the UK’s initial discussions with potential trading partners and in due course with the EU.

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.

