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The Preferential Origin Regime and Global Value Chains

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Think Piece

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Abbreviations and Acronyms

ASEAN	Association of Southeast Asian Nations
ECOWAS	Economic Community of West African States
EU	European Union
FTA	free trade agreement
GVC	global value chain
LRD	limited risk distributor
NTB	non-tariff barrier
SMEs	small and medium–sized enterprises
UK	United Kingdom

Abstract

Access to preferential import tariffs under a free trade agreement (FTA) is governed by clearly defined rules of origin designed to prevent non-members from enjoying the benefits. However, a company's ability to trade under preference even when it meets these rules, is subject to a number of other conditions and requirements. In particular, the documentary evidence required to demonstrate compliance with rules of origin can create an unintended second layer of protection and act as a non-tariff barrier to trade. This paper examines the current rules of origin requirement and how it applies to global value chains. It puts forth several recommendations for improvements in implementation.

1. The Preferential Origin Regime

Access to preferential import tariffs under a free trade agreement (FTA) is governed by clearly defined rules of origin with which firms wishing to trade under preference need to comply. Rules of origin are designed to be a non-tariff barrier (NTB) to trade, preventing non-members from enjoying the preferential tariffs. They are applied to prevent trade deflection, which occurs when non-members trans-ship their goods via an FTA member state to enjoy preferential tariffs. Goods that do not meet origin criteria cannot benefit from preferential tariffs under an FTA. However, if a company can demonstrate that the goods are originating, in theory, it should be eligible for preferential tariffs without further restrictions.

In practice, a company's ability to trade under preference is subject to a number of conditions and requirements, in addition to fulfilling the origin criteria. Some of these requirements are contained in the texts of FTAs. These are, for example, provisions concerning the documentary evidence that needs to be submitted to demonstrate compliance with rules of origin or involving the required type of origin certificate and period of its validity. Others are operational and/or administrative in nature and relate to the local legislation or the interpretation of the origin provisions by the local customs authorities at the point of importation of the goods. These are, for example, the rules for obtaining an approved exporter authorisation or the requirement to provide a certain type of documentation at the time of import.

These requirements and provisions are referred to as the broader architecture of the preferential origin regime and can inadvertently act as the second layer of restrictions to preferential trade in addition to the first deliberate layer — the rules of origin. They were put in place to enable and streamline trading under preferential origin rules. However, in practice they can have an equally restrictive impact as strict and non-inclusive rules of origin. The broader architecture of the preferential origin regime can restrict firms' ability to trade under preference. It can prevent companies whose products meet the rules of origin from being able to benefit from preferential rates, leading to increased cost, increased lead time, and loss of competitiveness. This is particularly relevant for firms with fragmented and highly dynamic global value chains (GVCs).

Companies operating within GVCs adopt various operating models to reflect internationally fragmented production networks and supply chains and to take account of direct and indirect tax considerations. One example can be a centralised principal model under which the principal company manages manufacturing and distribution activities. Contract and toll manufacturing where manufacturing is provided "as a service" are also commonly used.

Furthermore, digitalisation has enabled small and medium-sized enterprises (SMEs) to trade under more complex and fragmented business models and to increasingly integrate into GVCs. As a result, they often face the same challenges as larger firms when it comes to operating under the broader preferential origin regime and are impacted by its restrictive nature.

2. Barriers to Preferential Trade at the Point of Export and Import

Whether a company is sourcing materials and semi-finished products from its suppliers or purchasing the final product from a manufacturer located in another country, importing under preference can be a way to achieve savings for many importers. For exporters, preferential tariffs provide competitive advantage in the local market vis-à-vis non-FTA competitors. However, trading under preference represents a key area of compliance risk for private sector actors. Origin is determined and evidenced by the manufacturer in the preference-receiving country who exports the goods directly or indirectly to a customer in the preference-giving country. The customer importing the goods is responsible for presenting the preferential origin

documentation to customs officials at the time of import. If for any reason the preferential origin is refused, the customer is liable for the full rate of import tariffs. In such cases, the customer can pay the import charges in full or, depending on contractual arrangements, recharge the cost to the seller. In either case, the customer may decide to use a different provider going forward.

Before the goods can be exported, the manufacturer or seller is required to demonstrate that they meet origin criteria. This is done either with a certificate of origin obtained from a local customs authority, Chamber of Commerce, or other organisation, or by self-certification on a commercial document.

Obtaining an origin certificate from an external organisation can be time-consuming and involve additional costs. If a company exports a high volume of goods under preference and the origin documentation is required per consignment, the administrative burden of obtaining the origin certificates can be considerable.

Self-certification by companies is an increasing trend under many of the more recent FTAs. It removes the additional time and cost required to obtain origin documentation, but pushes the responsibility for demonstrating and verifying origin onto companies. This increases the risk of non-compliance, as companies do not always have the appropriate resources and customs knowledge to determine which products meet the origin criteria. Certification by customs authorities gives the importer an additional degree of confidence in its reliability, as the origin documentation has been reviewed and issued by an official organisation with experience in verifying origin. In its absence, importers need to rely on the information provided by their suppliers. As the importer is ultimately responsible for the correctness of the origin documentation, self-certification requires companies to work closely with their suppliers to ensure that appropriate procedures are in place and that records are kept for audit purposes. In the European Union (EU), a company wishing to provide an origin statement on its commercial invoices needs to also be authorised by the relevant local authorities. At the point of import, the most common reason for a refusal to grant preferential tariff is the incorrectness of the information provided and the inconsistency of the origin, customs, commercial, and transport documentation. When submitting an import declaration and claiming preferential import tariffs, a number of documents are required in addition to the origin documentation — for example, a commercial invoice, a bill of lading, an air waybill, and a packing list. An import declaration also needs to be completed. All these documents need to be consistent in the way they describe the goods, their quantity and weight, origin, ports the goods were shipped from, and so forth.

Local customs officials are in charge of verifying the submitted documents and granting preferential treatment. The local interpretation of origin requirements differs among countries, leading to situations where members of the same FTA have different practices for verifying origin at the point of import.

3. Impact of the Origin Regime on GVCs: Common Scenarios

Some of the most common issues when claiming preferential origin relate to direct shipment provisions and third-party invoicing. The direct shipment rule is included in the majority of FTAs in force. To be eligible for the preferential tariff, apart from meeting origin criteria, goods need to be transported directly from one FTA member to another. This is usually demonstrated by providing one shipping document covering the entire journey. Depending on the wording of the FTA, goods can be considered directly shipped even when they are transported through one or more non-FTA member states and temporarily stored, provided certain conditions are met. In such cases, evidence that the goods remained under customs control and were not further processed needs to be provided. As there is no unified template or way of providing such evidence, it is up to the local customs officials to decide whether the documents provided are sufficient.

The direct shipment provision is often a challenge for SMEs wishing to trade under preference. Due to the size

of their shipments, such companies may be unable to fill an entire shipping container and are thus required to share it with other firms. In such cases, before reaching the final destination, the container can often be trans-shipped via a different country to unload the other goods. Demonstrating that goods remained under customs control during this process can pose a problem. For this reason, the direct shipment provision under FTAs often represents a barrier to preferential trade for SMEs.

Provisions for third-party invoicing are particularly important for companies with internationally fragmented production models. Under such models, the flow of goods and the flow of invoices are often separated. Third-party invoicing provisions allow the goods to be invoiced by a company from a non-FTA country or via a company established in an FTA territory other than that of the exporter. Examples of FTAs with third-party invoicing provisions include the China-Singapore FTA, the Association of Southeast Asian Nations (ASEAN)-Australia-New Zealand FTA, the ASEAN-China FTA, and the ASEAN FTA. When third-party invoicing is not explicitly allowed under the text of an FTA, local customs authorities can question and potentially reject the preferential origin status when the goods were invoiced by a non-FTA member country.

The following examples demonstrate how the broader architecture of the origin regime impacts companies with fragmented GVCs.

1. Originating goods were traded between two member states of the Economic Community of West African States (ECOWAS). The invoicing was done via a parent (principal) company located in Dubai. Despite the importer providing a valid origin certificate and proof of direct shipment, preferential treatment was denied by customs officials in the country of import, because the commercial invoice was issued by a non-ECOWAS member and in a currency other than that of ECOWAS countries. This is one of the most common scenarios, and similar examples can be found under a number of preferential agreements.

2. Under a principal structure, it is often possible to have multiple invoices from the time goods leave the manufacturing facility and they reach the country of destination. For example, an invoice from the toll manufacturer to the principal company and from the principal company to the limited risk distributor (LRD) who then sells the goods to customers, while the physical goods move directly from the toll manufacturer to the final customer. In such cases, the local customs authorities can request to see one invoice covering the entire transaction. In addition to being an administrative burden, such requests are often difficult to fulfil for commercial reasons. Each of the invoices includes a profit margin or mark-up that is often commercially sensitive. For example, a company was selling goods between related entities and shipping them from the EU to South Korea. The South Korean authorities did not want to grant preferential treatment based on a commercial invoice covering only part of the transaction. The company proposed a number of solutions, including a pro forma invoice with no values. The customs authorities requested an origin statement to be placed on a delivery note document. This meant changing the way invoicing and commercial documentation was provided. As the company's systems were not set up to meet this requirement, all delivery notes with origin statements had to be issued manually per shipment for all exports to South Korea until a new invoicing system was introduced.

3. A company based in the United Kingdom (UK) was using a toll manufacturer located in Spain to sell EU-originating products to a customer located in South Korea. The company provided raw materials and commissioned the goods to be produced by a third-party toll manufacturer. The South Korean customer purchased the goods on an ex-works basis and picked them up at the factory in Spain. The UK-based company applied for an approved exporter status in the UK to be able to trade under preference with South Korea. The company was not the exporter of the goods, as the South Korean client took title to the goods at the factory in Spain. Under EU customs legislation, the Union Customs Code, an entity not established in the EU cannot act as an exporter and is required to name an indirect

customs representative. Such a representative acts in the company's as well as its own name and is jointly liable for customs charges. As a result, the goods were exported from the EU by a third-party customs agent with whom the UK entity had no contractual agreement.

The UK customs authorities agreed to issue an approved exporter authorisation, despite the fact that the UK entity was not the exporter. However, when the goods reached South Korea, the Korean customs authorities received an invoice declaration with the approved exporter number from the UK entity together with the shipping documentation from Spain and export documentation with the name of the third-party customs agent established in Italy as the exporter. The lack of consistency between the provided documents caused the South Korean authorities to question preferential origin and inspect the goods. The goods were eventually released and preferential tariff granted but with significant delay. This is a very common scenario and one that can also pose a challenge for SMEs. For example, a medium-sized T-shirt designing company in Sweden was using a contract manufacturer in Poland to fulfil its orders. Some of the items were sold to clients in South Korea on an ex-works basis, and it faced similar difficulties. Therefore, the preferential origin regime can have a restrictive impact on SMEs as well as large companies.

4. The Preferential Origin Regime Needs to Reflect the Complexity of GVCs

In the above scenarios, the goods were originating in the respective FTA member states, and the companies were able to provide documentary evidence of their originating status. Therefore, the goods met the origin criteria under the respective treaties. The preferential origin was challenged as the companies found it difficult to demonstrate consistency in the origin and commercial and transport documentation, owing to their internationally fragmented production structure. The additional cost and time necessary to meet the administrative and procedural requirements as well as the increased administrative burden and compliance risk of trading under preference can lead companies that are able to meet origin criteria to trade under full import tariffs.

Therefore, the preferential origin regime can act as an additional barrier to preferential trade for companies with internationally fragmented production. This impacts the functioning of GVCs and the utilisation rates of FTAs.

The origin regime should reflect the increasingly complex and changing supply chains and operating models by promoting harmonisation and simplification of the operational and administrative requirements at the point of import and export.

The interpretation of origin requirements should not be left to the local customs official at the point of import but should be addressed at the broader FTA or multilateral level.

At the FTA level, further guidance for local customs officials could be introduced either within the text or through the joint committees set up under most FTAs. Provisions for facilitating the movement of goods once the origin criteria have been met are included in the text of many FTAs. For example, the Pan-Euro-Mediterranean convention, the Canada-EU FTA, and the Singapore-China FTA state that minor discrepancies between the origin and commercial documentation should not lead to the invalidation of the origin certificate. This could be extended to include further clarification on the interpretation of the origin regime under specific conditions resulting from internationally fragmented production. Similar provisions together with provisions allowing for third-party invoicing could help to facilitate preferential trade.

At the multilateral level, organisations governing global trade, such as the World Trade Organization and the World Customs Organization, can promote harmonisation of the origin regime by developing best practices for its interpretation and for the simplification of the procedural and administrative requirements for demonstrating origin.

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.