

The EU's and the US's Preferential Arrangements– a Comparison

The Impact of Rules of Origin on Trade



Kommerkollegium
National Board of Trade

Various studies have shown how the cost of compliance with rules of origin often outweighs the benefits of the tariff preferences. The report “The impact of Rules of Origin on Trade“ summarises existing literature which confirms that rules of origin often act as a barrier to trade by having negative effects on both utilisation of preferences and trade flows. The report is summarised in this paper. The full report can be found at www.kommers.se.

The National Board of Trade is the Swedish governmental agency dealing with foreign trade and trade policy. Our mission is to promote an open and free trade with transparent rules. The basis for this task, given us by the Government, is that a smoothly functioning international trade and a further liberalised trade policy are in the interest of Sweden. To this end we strive for an efficient internal market, a liberalised common trade policy in the EU and an open and strong multilateral trading system, especially within the World Trade Organization (WTO).

As the expert agency in trade and trade policy, the Board provides the Government with analyses and background material, related to ongoing international trade negotiation as well as more structural or long-term analyses of trade related issues. We also publish material intended to increase awareness of the

role of international trade in a functioning economy and for economic development.

The National Board of Trade provides service to companies, for instance through our SOLVIT Centre which assists companies as well as people encountering trade barriers on the internal market. The Board also administers the Swedish Council for Trade Facilitation, SWEPRO.

In addition, as an expert authority in trade policy issues, the National Board of Trade provides assistance to developing countries, through trade-related development cooperation. We also host Open Trade Gate Sweden, a one-stop information centre assisting exporters from developing countries with information on rules and requirements in Sweden and the EU.

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Rules of origin concepts

Rules of origin

Rules of origin are rules that are used to determine the economic nationality of goods.

Preferential rules of origin

Preferential rules of origin are necessary in PTAs. In order to apply trade preferences under a PTA, it needs to be determined if a traded good originates in one of the partner countries.

Non-preferential rules of origin

Non-preferential rules of origin distinguish foreign from domestic goods in non-preferential trade, or so-called Most Favoured Nation (MFN) trade, where all countries face the same tariff.

Trade deflection

Trade deflection means transshipment of goods from non-preference countries through a low-tariff PTA partner to a higher tariff one. Preferential rules of origin aim to prevent trade deflection.

Product-specific rules of origin

Product-specific rules of origin are specific rules based on the Harmonised System. These rules stipulate the required working or processing that need to be carried out in order for the product to obtain originating status. The product-specific rules differ between different sectors/products.

Multiple product-specific criteria

If more than one product-specific rule applies for a good, there are multiple product-specific criteria.

Special technical requirement

This criterion prescribes for each product or product group certain manufacturing or processing operations that define origin or that do not confer origin. A special technical requirement is a form of a product-specific rule, common for textile and clothing products.

General across-the-board criteria

A general rule applicable across-the-board for all tariff items i.e. no product-specific rules.

General rules of origin

General rules of origin normally apply to all sectors, irrespective of product.

Cumulation

Cumulation allows imported materials to be used in the production of a good. It means that a product can be originating in one country in a preferential area by adding together processing done in different countries in the preferential area. There are different types of cumulation: bilateral, diagonal/regional and full, where bilateral cumulation is the most restrictive.

Self-certification

The system with self-certification by the exporter means that the exporter certifies the origin of the product. The administrative costs of the exporter and authorities in the exporting country are reduced.

Duty drawback

Duty drawback means that the customs duties paid for intermediate goods used in the production of a final product, which is exported, is refunded.

General tolerance rule

The general tolerance rule stipulates a maximum percentage of non-originating materials that can be used in production without affecting the defined origin of the final product.

Single transformation

Single transformation means that imported fabric can be used in the production of clothing and that just a single transformation is required in order to obtain origin status.

Double transformation

Double transformation means that textile or clothing products have to be made out of a two-stage transformation process: stage one being the yarn woven into fabric and stage two the fabric made into clothing. It implies that beneficiary countries are not allowed to import fabric and then make it into clothing.

The European Union's (EU's) trade preferences for textiles and clothing have lower utilisation and smaller trade flows than the US's preferential arrangements with developing countries. This is revealed in a comparison of the preferential rules of origin in the EU's GSP and the US African Growth and Opportunity Act (AGOA). The US's AGOA, with more relaxed rules of origin, is associated with higher utilisation rates of trade preferences as well as a large increase in developing countries' exports to the US.

The textile and clothing sector and the EU's and the US's preference schemes

The textile and clothing sector represents a large proportion of the exports from many developing countries to industrialised countries such as the EU countries and the US. It is a sector that remains subject to relatively high tariff barriers, making the use of the preferences for textile and clothing products valuable and crucial for many developing countries.

Consequently, the existence of well-designed rules of origin that enable traders to actually make use of these tariff preferences in various preferential trade agreements (PTAs) is essential. Many developing countries do not have the industrial infrastructure required to manage every stage of production: from producing the thread and weaving the cloth, to sewing the finished garment. Yet, the use of originating fabric (from one of the PTA parties) in the production of clothing is often required in order for the beneficiary country to qualify for origin and thereby benefit from preferential market access to the EU's and the US's markets.

Strict rules of origin in EU's General System of Preferences

One of the main preferential trade arrangements that regulate trade between the EU and developing countries is the EU's General System of Preferences (GSP). The rules of origin for textile and clothing products under the EU's GSP scheme has been criticised for being too stringent and hard to comply with. The rules of origin for textile and clothing products are generally more restrictive than for most other sectors, consisting of a combination of product-specific criteria. In the EU's GSP scheme, textile and clothing products are not covered by the general tolerance rule that allows for relaxations from the product-specific rules. This implies that one way to fulfil the rules of origin is removed.

More relaxed rules in US African Growth and Opportunity Act

In the US, the African Growth and Opportunity Act (AGOA) grants temporary custom relief for importation from a group of African countries into the US. Under the AGOA, the tariff preferences of the US's GSP system are extended to more than 1,800 products, including a large proportion of textile and clothing products. In addition, there are special rules of origin which grant temporary custom relief for importation of clothing products from a group of African countries into the US. Distinctions are made between "lesser developed countries" and other AGOA countries. The so-called lesser developed countries are subject to more relaxed rules of origin and may source fabric and yarn from anywhere in the world and still qualify for duty-free access when exporting their final clothing product to the US market.



Lower usage of the EU’s preferences for textiles and clothing

With regard to the EU’s standard preferential trading regime with developing countries, studies indicate relatively low utilisation rates of the preferences for textile and clothing products, varying between 0 and 50 per cent. When looking at the more generous preferences granted to the Least Developed Countries (LDCs) under the Everything But Arms (EBA) initiative (within the EU’s GSP), the utilisation rates are higher, between 57 and 90 per cent. Overall, the textile and clothing sector stands out as one of the sectors with the lowest utilisation rate of trade preferences granted by the EU to developing countries. The countries that have recently benefited from derogations from the EU’s rules of origin (Laos, Cambodia and Nepal) appear, however, to have considerably increased their utilisation rates of the EU’s preferences for textile and clothing products.

Higher usage of the US’s preferences for textiles and clothing

With regard to the US preferential scheme for developing countries, trade preference utilisation rates for textile and clothing products appear to be higher than the EU’s. The utilisation rates of the trade preferences for clothing products among lesser-developed countries (granted the more relaxed rules of origin under the US AGOA) amount to more than 90 per cent. When considering all countries, benefiting from either the AGOA or the US GSP scheme, the data shows a utilisation rate of 57 per cent.

Higher preference margins under the EU’s preferential regimes

When evaluating utilisation rates, it is important to consider the preference margins. Higher preference margins are likely to lead to higher utilisation rates – there is more to gain. The preferential margins for

textile and clothing products in the EU's and the US's preferential arrangements are approximately the same for African LDCs. LDCs in sub-Saharan Africa benefit from duty-free and quota-free market access (under the EU's EBA and the US's AGOA). Non-African LDCs benefit from duty-free and quota-free market access for textiles and clothing under the EU's EBA initiative as well as under the special provisions in the US's GSP for LDCs. For non-LDCs, the number of textile and clothing products benefiting preferential market access to the EU is, however, much more inclusive than under the US's preferential trade arrangements. Hence, the number of products benefiting from preferential market access and the preference margins for textiles and clothing are higher for the EU's preferential schemes than the US's preferential schemes. Despite higher preference margins, the utilisation rates of the EU's preferences for textile and clothing products are still lower than those for the US's preferential schemes. This suggests that the EU's more difficult and strict rules of origin are likely to be a hidden trade barrier.

Increased exports following the introduction of the US AGOA

When comparing total aggregated trade flows, the data shows that the path of African clothing exports to the EU and to the US were similar before 2000. After 2000 though, when the AGOA entered into force, the clothing exports to the US increased substantially (by 300 per cent over five years) while the exports to the EU declined during the same period. The decline in textile and clothing exports from African developing countries to the EU between 2000 and 2005 amounts to 60 per cent in value and 50 per cent in volume. Only few developing countries managed to increase their exports to

the EU during this period. It is interesting to note that Cambodia, Myanmar and Bangladesh, which experienced the highest increase in textile exports to the EU, all belong to one of the three regional groups benefiting from regional cumulation possibilities under the EU's GSP. Moreover, Cambodia is one of the three developing countries that have been granted derogations from the EU's rules of origin for certain textile products. Hence, the introduction of cumulation possibilities and derogations from the rules of origin could have had a positive impact on the growth in textile and clothing exports from these countries.

More relaxed rules of origin increase exports and use of preferences

A comparison of the EU's and the US's trade preference utilisation rates and total aggregated trade flows in textile and clothing products from developing countries suggests that the introduction of more relaxed rules of origin are likely to have a positive (less obstructing) impact on trade. The positive effect seems to follow from: the introduction of a single transformation rule; the granting of derogations from the origin rules in the textile and clothing sector; and generous cumulation possibilities.

How to further facilitate trade and utilisation of preferences

The rules of origin in the EU's GSP have been revised with some relaxations in the rules as a result and the new rules apply from 2010. The main difference in the textile and clothing sector is that a distinction between LDCs and non-LDCs has been made, granting LDCs easier access to the EU market by less restrictive rules of origin.¹ It is, however, dubious whether enough relaxation in the rules has been made in order to achieve the stated main

1 After the 2010 reform of the EU's GSP rules of origin, the rules of origin for LDCs are more comparable to the US's AGOA rules of origin for lesser-developed countries. For most textile and clothing products, a double transformation is no longer required for LDCs. This implies that LDCs can import fabric and make it into clothes and still fulfill the rules of origin, similar to lesser-developed countries in the US's AGOA.

objective with the reform: simpler and more development-friendly rules of origin.

The Commission has put forward a proposal for a new GSP scheme to the Council and the European Parliament. The major change proposed by the Commission is a substantial reduction in the number of beneficiary countries. The rules of origin are regulated in a separate legislation, the Commission Regulation (EU) No 1063/2010. No changes are therefore foreseen to the rules of origin in the present negotiations on the EU's GSP system within the Council and the European Parliament. In other words, if trade preferences are to be used to a greater extent, the rules of origin in the Commission Regulation (EU) No 1063/2010 will need to be opened up and further revised.

The nationality of goods is determined by rules of origin

Rules of origin are a tool to determine the nationality of goods and to ensure that trade preferences are not misused through transshipment of goods, i.e. to prevent trade deflection. As such, rules of origin are an inevitable part of PTAs. Rules of origin define the sufficient level of processing that must take place or the amount of value to be added in a given country in order for a product to be considered to have its origin in that country.

Trade preferences and rules of origin acts in opposite directions

Over the past century, the specialisation of production has led to an ever-increasing degree of trade and PTAs have become an important trade policy tool. Intricate systems of trade regulations and



trade agreements have been created and special privileges have been agreed upon, granting preferential market access to certain countries and regions for a variety of political and economic reasons.

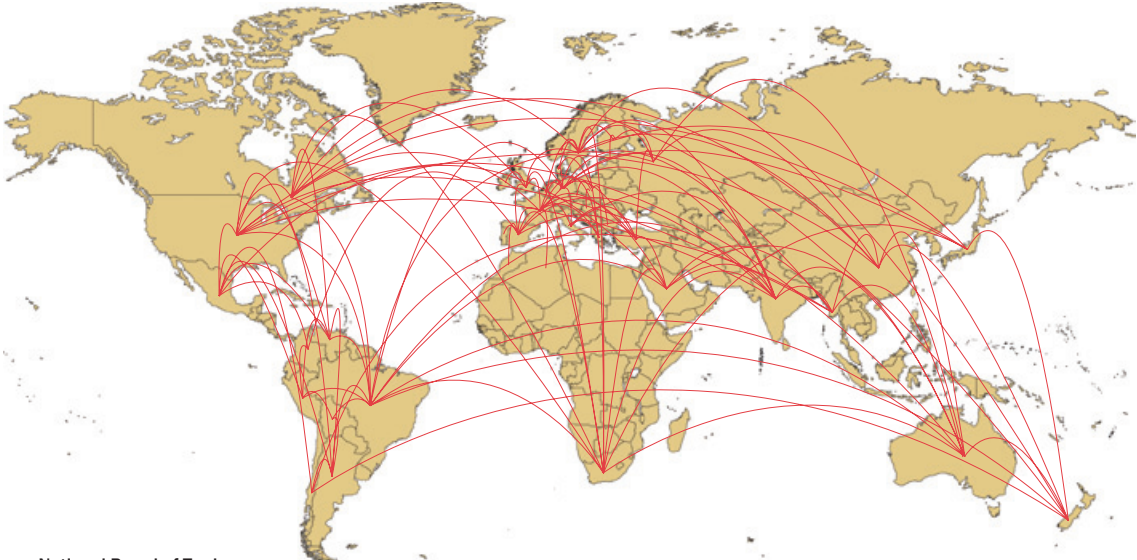
Trade preference schemes consist of two primary parts, acting in opposite direction. Those are trade preferences – the granting of market access by reduced tariff rates and/or less restrictive quotas, and the constraints – eligible countries and products, and the rules of origin. The objective of PTAs is to facilitate trade, but the costs of complying with rules of origin often obstruct this objective. Various studies have shown how the cost of compliance with rules of origin often outweighs the benefits of the tariff preferences. Hence, it is clear that in these cases, the rules of origin are too strict.

Preferential rules of origin are an integrated part of every PTA, both reciprocal free trade agreements (FTAs) and non-reciprocal arrangements such as the GSP. The principal objective and economic justification of rules of origin is to prevent trade deflection: to avoid goods from non-preference countries being transhipped through a low-tariff PTA partner to a higher tariff one. Strict rules of origin are sometimes motivated by the argument that they stimulate integrated production structures in developing countries and, thereby, promote economic development. However, most of the literature opposes this view, arguing instead that more relaxed rules of origin are more likely to promote economic development by encouraging specialisation and the sourcing of inputs from the most competitive sources.

With the growing number of PTAs around the world, customs and traders are faced with an increasingly onerous cluster of different and conflicting rules of origin, often referred to as the “spaghetti bowl”. In the absence of a common, harmonised set of preferential rules of origin, each PTA contains its own set of rules of origin, normally in an exhaustive protocol (between 50 – 300 pages long) annexed to the agreement. With currently around 300 PTAs in force, an intricate flora of rules of origin has appeared. With different rules of origin in different PTAs, traders face a cumbersome system.

As the number of PTAs increases, and the division of production becomes more and more global, the need for simple, user-friendly and trade-facilitating rules of origin has become both urgent and topical.

Figure 1. The spaghetti bowl of trade agreements



Source: National Board of Trade

Rules of origin give rise to costs

There are costs arising from satisfying the rules of origin. These costs can be divided into production costs and administrative costs. Production costs arise from changes in production that are caused by the rules of origin. Administrative costs arise from the administrative procedures required to prove compliance with the rules of origin.

Stricter rules of origin connected to lower use of preferences

Rules of origin regimes with multiple product-specific criteria have in general a more negative effect on trade than regimes with an across-the-board criterion for the majority of goods. There is often a positive correlation between high tariff rates and strict rules of origin. Furthermore, the utilisation rates of the trade preferences are lower in trade regimes and in product groups where the rules of origin are stricter. With regard to the EU, the textile and clothing sector stands out as an example of a sector with a particularly low utilisation rate of trade preferences.

General rules of origin facilitate trade flows

Studies that have analysed total aggregated trade flows between PTA parties indicate that while restrictive product-specific rules of origin undermine aggregated trade flows, general rules of origin that allow for flexibility in the application of the product-specific rules (such as cumulation, the general tolerance rule and self-certification) can limit the trade-obstructing effect of the rules of origin.

Production is increasingly global

The increase in economic fragmentation has added to the complexity of determining the economic origin of goods. As discussed in the report “Made in Sweden?”² and the soon to be published report “Business Reality and Trade Policy – Closing the Gap”³, fragmented production processes and global sourcing networks are integral parts of the world economy, and integrated production structures within a single country no longer seem to be a viable option. If rules of origin are not designed in a way that reflects how firms organise their production, the rules will comprise ever-greater barriers to trade, particularly in light of the trend toward global value chains.

Firms in different countries are often involved in different steps in the production processes of products. The opportunity to trade with intermediate goods is necessary for an efficient production chain. Consequently, rules of origin need to be outlined as to comply with international trade in inputs rather than international trade in complete products.

The European Commission points out the need to relax the rules of origin in the communication “Trade as a driver of prosperity” (p.59)⁴:

“Global commerce is characterized by large and increasing volumes of trade in intermediate products. Producers take advantage of different costs in different locations to source the cheapest inputs possible. Allowing producers access to raw materials or intermediate products from low cost international sources through relaxed rules of origin (RoO) is therefore vital. This will generate economic activity in the beneficiary country and facilitate development. In developing countries, where labour is most often abundant and cheap, even simple manufacturing operations that provide only low levels of value added can create important job opportunities.”

2 National Board of Trade, 2011

3 National Board of Trade, 2012

4 EC 2010.

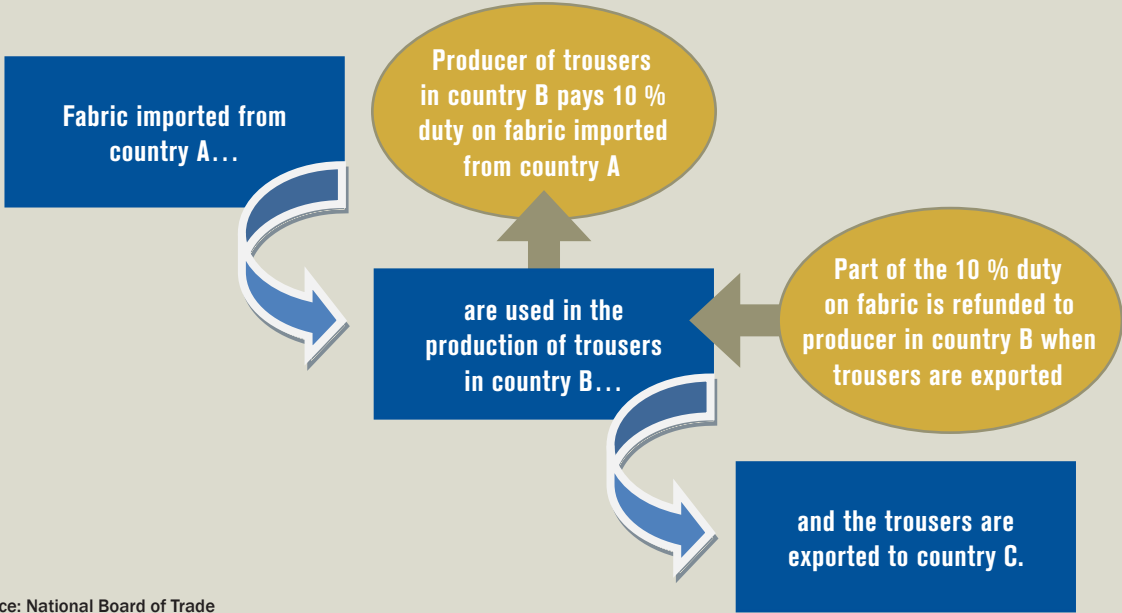
One way to adapt to global value chains is to allow duty drawback. Duty drawback means that the customs duties paid for intermediate goods used in the production of a final product, which is exported, is refunded. This implies that the duty of the intermediate good loses its importance to the producer of the final good. The possibility to use duty drawback is argued to encourage trade with intermediate goods and to secure that the export industry has

access to efficient inputs. A prohibition against duty drawback affects decisions relating to sourcing of inputs by firms exporting within the preferential trade area, encouraging firms to switch from imported inputs from non-participating countries towards sourcing inputs from participating countries. If the intermediate goods are more expensive within the PTA area, a duty drawback prohibition could have negative effects on the industry.

Figure 2. Duty drawback

The trousers producer in country B is using fabric as an intermediate good when making trousers. The producer pays a 10 per cent customs duty on the fabric when imported from country A. When the final product, the trousers, is exported to country C, the producer in country B is reimbursed the duty paid for the fabric. The producer can only be reimbursed a part of the 10 % duty, depending on how much of the imported fabric that is used in the trousers. There will be spillovers for which the duty cannot be reimbursed.

The possibility to use duty drawback is argued to encourage trade with intermediate goods and to secure that the export industry has access to efficient inputs.



Source: National Board of Trade

Conclusions

In the EU's preferential trade arrangements with developing countries, there is a positive correlation between high tariff rates and strict rules of origin. Strict rules of origin appear to have a negative effect on both utilisation rates and total aggregated trade flows. The textile and clothing sector exemplifies these findings, having high tariff rates and strict rules of origin. Rules of origin within PTAs, designed to support developing countries, are having a negative effect on trade flows. Consequently, the full potential of the preferences designed to benefit these countries is not being realised.

The US's AGOA regime, on the other hand, is more relaxed when it comes to rules of origin than the EU's GSP⁵, leading to higher utilisation rates of trade preferences as well as to a large increase in developing countries' exports to the US. Hence, this supports the theory that more relaxed rules of

origin encourage specialisation and sourcing of inputs from the most competitive suppliers, and thus facilitate trade.

Preferential market access can in practice be meaningless if the rules of origin are too strict. Nevertheless, some general conclusions emerge on how to diminish the negative effects stemming from rules of origin: allowing for greater flexibility by including provisions on full cumulation and generous tolerance rules; avoiding multiple product-specific criteria, e.g. by the introduction of a general across the board criteria; allowing for duty drawback; allowing for greater relaxation in the product-specific rules by e.g. the introduction of a single transformation rule for all beneficiary countries instead of the strict double transformation rule; by allowing for self-certification that limits the administrative costs linked to proving the origin; and by generous granting of derogations to LDCs from the origin rules in the textile and clothing sector.

5 Based on the pre-2010 rules of origin in the EU's GSP.



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