

Rules of Origin in Emerging Asia-Pacific Preferential Trade Agreements: Will PTAs Promote Trade and Development?

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WTO Requirements for PTAs

PTAs are allowed as exceptions to GATT/GATS Principles of Non-Discrimination and National Treatment:

GATT Article XXIV requires members of free trade agreements and customs unions to notify the agreement; PTAs must cover substantially all trade, exceptions or “sensitive products” must be incorporated within a “reasonable period of time” and agreements must not raise barriers to non-member commerce relative to the situation prior to the PTA enactment.

GATS Article V requires PTAs covering services to be notified to the Council for Trade in Services, substantial coverage of services, elimination of discrimination between members; must not raise the overall level of barriers to service commerce of non-members.

WTO Requirements Continued

- Article XXIV and Article V Notifications are required for any FTA or CU involving a Developed Country;
- The Enabling Clause (1973) was added as a special encouragement to participation in world trade by less developed and developing countries;
- PTAs under the enabling clause are between developing countries or are non-reciprocal preference programs granted by more developed to less developed countries;
- Enabling clause PTAs are exempted from some of the requirements under Art. XXIV but must still be notified, but ***do not create an impediment to multilateral trade liberalization*** (This issue will be returned to in the policy recommendations under aid for trade).

Proliferation of PTAs in the Asia-Pacific Region

- UNESCAP has identified at least 110 PTAs involving member countries; See: <http://www.escap.org/tid/pta%SFapp/>
- 63 (excluding mere framework agreements) are in force involving at least one developing member country (8 under the enabling clause, 28 under Art. 24; 14 under Art. 24 & 5; and 13 that are not notified).
- ADB (ADO 2006 update) will provide a mapping of PTAs involving at least 1 developing member country (DMC) and these amount to 37 notified agreements, 42 agreements in force that are not notified and upwards of 50 more that are being negotiated ;
- With the collapse of the WTO Doha Round Negotiations in July 2006, it is expected that PTAs will become the immediate focus of trade negotiations;
- Thus, further proliferation of bilateral PTAs is the trend in the region and the world.

Whether or not PTAs have been notified conveys information about the nature of the agreement

- Notification implies agreements are consistent with requirements under the 3 “escape routes” from Article I and the principle of non-discrimination;
- Non-notification implies agreements that are not compliant with the spirit of GATT Article XXIV and indicate one or more parties to such agreements do not wish to even be responsive to requests for consultation from contracting members under the enabling clause.

Examples of Non-Notified Agreements that have entered into force for at least one year

- India's Bilateral Free Trade Agreements with other SAARC Member Countries (India-Sri Lanka 2001; India-Bhutan 1995; etc.)
- PRC Bilateral Free Trade Agreements outside the region (PRC-Niger FTA 2005) and with SAARC Members (PRC-Pakistan 2005);
- Pakistan FTA with Sri Lanka 2005; Pakistan FTA with Malaysia 2005;
- Singapore FTA with Jordan 2004; Singapore FTA with India 2005;

The more recent of these agreements may well be intended to be notified but the fact that the partners have been in no hurry to do so indicates these are not likely to be comprehensive in coverage and may require waivers from WTO/GATS commitments.

For PTAs that have been notified; the choice of which of the three possible types of notification is chosen also conveys information about the nature of the PTA

- Enabling Clause Notification signifies agreements exclusively involving developing countries and indicates exceptions that are expected to be permanent or longer than “a reasonable period” as required under Art. 24 and have weak or ill-defined rules; PTAs notified under the clause are likely to exclude sectors where gains from liberalization are the greatest, hence these PTAs have a small impact at best; they are also likely to be unimpressive to businesses and may not promote much new investment;
- Article XXIV Notification signifies willingness of partners to comply in principle with requirements of coverage of substantially all trade and that limited exemptions be ended in a period of within 10 years and that such agreements do not raise barriers to non-beneficiaries;
- Article XXIV plus Article V Notification conveys that a PTA is likely to be WTO+ and involves serious political commitment and major economic impact including on investment and services.

Rules of Origin in New PTAs in the Asia-Pacific Region

- UNESCAP's APTIAD Data Base provides a summary view of rules of origin in existing PTAs involving member countries;
- The data base provides information on cummulation; deminimis and drawback provisions and the type of rules of origin used in the PTA; however, it does not provide detailed information by HS Chapter or specifics when combined tests are required to convey origin as is the case in many PTAs;
- The rules of origin for processed or manufactured products include use of one or more of three tests for “substantial transformation” principle (for raw materials a simple wholly obtained test applies):
 - 1) a change in tariff heading or CTH test
 - 2) a minimum content or value added (percentage) test
 - 3) a specified process test

Assessment of Rules of Origin in Emerging Asia-Pacific PTAs: Within Hub-Spoke Systems and Across Major Hubs

- Detailed information is provided on rules of origin notified to the WTO under GATT Article XXIV but not under the enabling clause;
- Rules of origin usually are covered in a chapter of every agreement but as most agreements have product specific rules of origin, these are contained in annexes ranging in length from 100-300 pages organized by HS Chapter;
- We examined rules of origin provisions in PTAs entered into by five major Asia-Pacific hubs: Japan, Rep. of Korea, PRC, Singapore and Thailand;
- Concentrate on Manufacturing Product Rules of Origin;
- Japan along with the PRC and Republic of Korea are the three largest and most industrialized economies in East Asia;
- Singapore and Thailand are the most active and prolific in Southeast Asia in negotiating and signing PTAs.
- Hence, these we consider to be the “major hubs” of immediate interest, although India, Australia and the USA may also be considered as “hubs” as well.

Rules of Origin in Asia-Pacific Hub-Spoke Systems: Japan

- Japan Economic Partnership Agreements usually combine a CTH and a Value Added Test in rules of origin for processed and manufactured goods;
- VA percentage differs between agreements (e.g. 50% for Mexico; 60% for Singapore in most chapters);
- Chapter 24 (Tobacco Products) specifies a 70% content requirement in the Japan-Mexico FTA and does not allow cummulation; whereas the minimum content is 60% for the FTA with Singapore and allows cummulation.
- Chapter 86 (Transport Eq.) specifies CTH plus a 65% content for road vehicles in the Mexico-Japan PTA but only a CTH rule in the JSEPA; similarly for Chapter 30 (Pharmaceuticals) CTH plus 50% VA is specified with Mexico but only CTH with Singapore.
- Clothing (CH 62&63) specifies CTH for Mexico-Japan but CTH plus 60% VA for JSEPA.

Rep. of Korea Bilateral PTAs

- Korea's PTAs with Chile and Singapore usually also specify a combined CTH and VA Test rule of origin;
- VA test for the FTA with Chile is 45% for the build-up method of accounting and 30% for the build-down method but is 55% for the FTA with Singapore;
- Chemicals (CH. 28 & 29) provides different percentages for content between these two chapters in the FTA with Chile and a CTH rule with some cases of specified process (SP) rules in the case of Singapore;
- Clothing (Ch 61 & 62) rules of origin in the Singapore FTA are a combination of CTH, VA (55% regional) and SP, but only SP for Chile; yet Footwear (Ch 64) does the opposite (see Table 2 in paper) Chile has CTH plus VA and Singapore only has CTH.
- Moreover, in the agreement with Singapore, Korea phases out tariffs on textiles (Ch 50-60) over 5 years and for clothing over 10 years!

PRC Bilateral FTAs: Hong Kong SAR and Macao SAR

- PRC FTAs with its Special Administrative Regions of Hong Kong and Macao (both separate customs territories) are notified under Articles XXIV and GATS Article V, yet coverage is very limited in terms of agricultural exclusions and limited sector coverage in manufacturing;
- VA rule is consistent percentage across agreements: National Content of 30%
- In Machinery the tests include CTH, SP and VA but for Chemical Products CTH and SP for Hong Kong but VA and CTH for Macao SAR;
- Electronics is consistent in both but requires CTH, VA (30% National) and SP as well.
- Textiles and clothing (by far the most important chapters) combined CTH and SP Tests (assembly or sewing);

Singapore's Globe Straddling FTAs: USA, SEP and EFTA

- Singapore is the most active Asian Nation in the area of PTAs; with truly global networks of trade agreements: EFTA (Norway, Iceland, Switzerland), SEP (Chile, New Zealand, Brunei) are examples. It is also the first ASEAN member to join a Free Trade Agreement with the USA;
- The rules of origin differ dramatically across Singaporean PTAs with very comprehensive (almost 300 pages) of product specific rules with the USA (similar to NAFTA in most respects); more simple and flexible rules of origin in SEP and EFTA-type rules of origin (mainly specifying maximum non-originating content rules and SP rules with CTH);
- In textiles and clothing there are very detailed product-specific rules of origin in the US case with CTH and SP rules (even though Singapore is a very minor player in the US textile and clothing trade—the reason being that the US was concerned that Singapore may be a “back-door” for competitive Asian suppliers;
- VA rules vary across agreements: 45% or 35% (depending on build up or build down method) for the USA; 45% for SEP; 50% non-originating maximum for EFTA.

Singapore Bilaterals Continued

- Singapore has also entered into PTAs without notifications involving South Asian partners and also with Jordan;
- Bilateral FTAs with Australia and New Zealand provide a potential model for consideration, with general rules of origin and provision for cumulation, de minimis and some flexibility for businesses;
- However, there is no harmonization across the FTAs with Australia and New Zealand (VA 50% in Australia, 45% in New Zealand);
- Singapore has zero applied tariffs for all lines except 7 alcoholic beverage chapters, so it does not worry about trade deflection.

Thailand's Bilateral Agreements: Australia and New Zealand FTAs

- Australia and New Zealand have entered into free trade agreements with Thailand both being members of the ANZCERTA;
- However, there is no harmonization of rules of origin between ANZCERTA and these two FTAs with Thailand, nor is there harmonization even between the rules of origin within these FTAs;
- Thai-Australia has more extensive VA (55% regional content) than does Thai-NZ (only in textiles and clothing is there a 50% regional content rule along with CTH); TAFTA has a SP and CTH rule for clothing in addition to VA; and a CTH for textiles in addition to VA;
- If New Zealand and Australia can't harmonize rules of origin, who can?

The Down Side of PTAs: Tariff Discrimination vs. Non-Members

- A case study of apparel, textile fabrics and yarns, and footwear in the case of the US import market was conducted using post-quota era data (2005);
- The method is to look at all clothing categories in the US tariff code and to aggregate up the tariff duty actually paid by each supplier and to do the same for the customs value of imports, then to calculate the ratio of duties paid to the customs value of imports in clothing (then the same for textile intermediate products and footwear);
- We separate non-preferential suppliers from preferential suppliers to the US market and compare ratios; the difference is the “margin of preference” arising from tariff discrimination;
- The results are shown in the tables 6-8 in the report (as follows).

Tariff Discrimination: Clothing in the US Market

- Non-Preferential Suppliers to the US market paid import duties of \$7,437 million on \$51,297 million of clothing shipments to the US market for an effective duty rate of 14.32%;
- Preferential Suppliers paid total duty of \$562 million on shipments worth \$22,280 billion for an effective duty rate of only 2.52%, implying a margin of preference of nearly 12% on average;
- Some of the most competitive Asian suppliers face even higher tariff discrimination than the average: Indonesia's effective duty rate of 17.88% gives Mexico (effective duty rate of 0.58%) and Canada (0.51%) huge margins of preference; similarly Mongolia paid an effective duty rate of 18.32%!

Tariff Discrimination: Textile Intermediate Products in the US Market

- Fewer Suppliers than clothing and tougher competitive positions due to large global capacities so profit margins are razor thin;
- Effective duty rate for non-preferential suppliers is 10.07 per cent (2005) data;
- Effective duty rate for preferential suppliers is effectively zero (0.19%); for a nearly 10% margin of preference;
- Again some Asian suppliers pay even higher effective duty rates as they export mmf fabric and yarn and face peak US tariffs; Indonesia (12.07%; Malaysia 11.98%; Thailand 11.28% and Viet Nam 11.05%).

Non-Agricultural Market Access Negotiations and Tariff Discrimination: the Value of the Swiss Formula

- The US and EU tend to have tariff peaks in labor-intensive manufacturing sectors like textiles, clothing and footwear (US peak tariffs on mmf clothing are over 30% for example);
- The Hong Kong Ministerial in December 2005 adopted the “formula approach” to tariff reductions rather than the linear reduction approach (whereby all tariff lines are cut by the same percentage);
- Under the “Swiss Formula” peak and high tariffs are cut by a larger percentage than are low tariffs with the effect of sharply reducing tariff dispersion; this would greatly reduce margins of preference in PTAs.

Can GSP Compensate Developing Asia-Pacific Countries for the Tariff Discrimination Effects?

- GSP can partially compensate countries that are not otherwise granted preferential access to major markets like the US, EU and Japan under free trade agreements;
- However, as the Sutherland Report of 2004 pointed out GSP rules of origin are highly restrictive and ensure that only a small amount of trade benefits;
- In Asia and the Pacific GSP utilization rates were calculated in the US market (which reports imports under various import programs) as a share of total US imports from those countries;
- India (25%); Thailand (16%), Indonesia (12%) had among the highest utilization ratios because of their diversified export base; paradoxically Armenia (58%), Kazakhstan (20%), Fiji (29%) and Samoa (40%) had high utilization ratios because their major export product (minerals, fish) received GSP treatment.

GSP Utilization Cont.

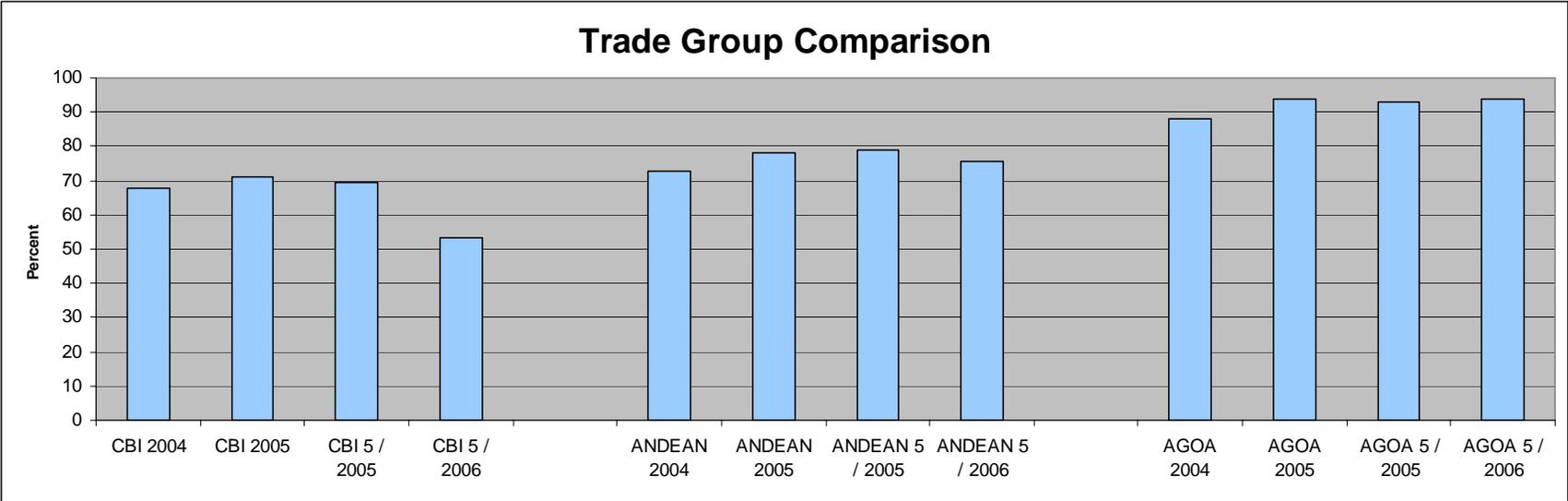
- Small and isolated low-income developing countries that most need GSP are in fact unable to avail of it to any large extent;
- Less than one per cent of import shipments benefit from US GSP for Bangladesh, Bhutan, Afghanistan, Cambodia, Maldives, Mongolia and some Pacific Islands;
- GSP use was very low in Nepal (2-3%), Pakistan (3%), Sri Lanka (6%) and most Pacific Island states.

Utilization of US Free Trade Agreements

- FTA partners benefit much more than GSP beneficiary countries, with shares of duty-free imports over 60% for Mexico, over 50% for Chile and fast-growing (from just 2% to over 20% between 2004-2006 YTD for Jordan);
- Developed countries (Canada has over 75% use of NAFTA treatment in its shipments to the US) have a stronger capability than developing countries to take advantage of FTAs; Australia has quickly increased its FTA use from 36% in 2005 to over 40% in 2006 YTD;
- Hence, FTAs will open an even bigger gap between developed and developing countries that current GSP cannot compensate for.

Utilization of Special Non-Reciprocal PTAs: a Case Study of the US Market for Clothing

Figure 1: Per Cent of Imports Covered by US Non-Reciprocal Preferential Trade Arrangements



Proposals for Disciplines and Reform in Uses of Rules of Origin

- Learn from experience in negotiations on harmonization of non-preferential rules of origin—harmonization not a practical prospect so move on to more realistic work program for preferential rules of origin;
- Pan-European Cummulation System allows cummulation across spokes and this practice should be encouraged in other hub-spoke systems in order to develop efficient networks and avoid trade diversion in intermediate inputs;
- Introduce choice/flexibility for firms in compliance with rules of origin including choice of value-added content (maximum non-originating or minimal regional content) or a specified process test; set lower content threshold for developing countries;

Proposals for Disciplines and Reform in Uses of Rules of Origin, cont.

- Allow averaging of regional content over shipments in a given time period rather than demanding that every shipment meet a rigid value-added or minimum content rule;
- Require timely notification of new PTAs under one of the 3 notification routes: enabling clause, Article 24, Article 5;
- Enforce requirements under each of the 3 routes in the WTO; require that enabling clause notified agreements come under Article 24 and Article 5 within a “reasonable period of time” (10 years).