OPINIONS

Free Trade Agreements: Compliance with Rules of Origin and Utilisation of Preferential Tariffs

Jessica Gladstone

Cintia Aguilar Flores

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Introduction

Since the creation of the World Trade Organization (WTO) in 1995, over 400 agreements covering trade in goods or services have been entered into between WTO members, with many more still being negotiated. These include the Trans-Pacific Partnership (TPP) Agreement, the Regional Comprehensive Partnership Agreement (RCEP), the Pacific Alliance in Latin America, and the Tripartite Agreement in Africa. The intention is clear: to eliminate tariff and non-tariff barriers, liberalise international trade, widen market access, and strengthen investment protection and liberalisation.

However, despite the proliferation of free trade agreements (FTAs), utilisation rates are lower than may be expected and more analysis of the benefits actually derived from such agreements is required in order to make them as effective as possible. In 2016, the European Commission published a report on the implementation of the EU-South Korea FTA, which found that the overall use of tariff preferences under the FTA (also known as the preference utilisation rate (PUR)), was only 65 per cent during the fourth year of FTA implementation.[1] Other studies, that have examined the extent to which EU exports enter partner countries under the preferential tariffs negotiated under the EU's FTAs, found that the average PUR for EU exports was around 75 per cent in 2013.[2]

Rules of origin (RoO) have been identified by some as the primary reason why FTAs are under-utilised, given the regulatory burdens these provisions can impose on businesses.[3] Given that each FTA may have different RoO, the proliferation of bilateral and regional FTAs means that compliance costs related to RoO are likely to increase. Government officials negotiating current and future FTAs need to carefully evaluate these costs as they design RoO.

Rules of origin

For trade in goods, FTAs liberalise trade through preferential tariffs, which are lower than those offered by a country under its WTO goods tariff schedule. Preferential tariffs are charged on the basis of a product's origin through RoO—the rules used to determine whether a product is eligible for preferential tariff rates under an FTA. RoO prevent trade deflection, whereby imports from third countries not party to the FTA enter the territory and benefit from the lower tariff. Without RoO it would be difficult to maintain the integrity of FTAs and the FTA zone.

RoO, however, are technically complex and vary depending on the specific agreement. For manufactured and processed goods, RoO are particularly difficult given the use of intermediate inputs and the complex nature of modern supply chains, which often involve manufacturing operations taking place in different countries or customs territories. The calculation methods adopted under specific RoO across FTAs will also differ depending on the product.

The types of criteria used to determine origin include: a change in tariff heading, also known as the CTH test; the value-added criteria or percentage test; and the specific manufacturing process test.

For example, under the EU's non-preferential rules of origin, the manufacture process which turns fabric into hats will result in a change in customs classification heading of the product under the CTH test. This means that the hat will be classified as originating in the country in which its manufacture occurred, rather than taking into account the country of origin of the fabric.

To take another example, applying the value-added criteria test, the EU-South Korea FTA stipulates that unless a good has been "wholly obtained" (i.e. a vegetable grown) in South Korea, exporters to the EU have to prove that the good has been "sufficiently processed" in South Korea to benefit from the preferential rates. This test typically varies according to the type of product being exported. For cars, for example, an exporter from South Korea to the EU would have to show that no more than

[1] Commission, "Report from the Commission to the European Parliament and the Council — Annual Report on the Implementation of the EU-Korea Free Trade Agreement", COM(2016) 268 final, *http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52016DC0268&from=EN* [Accessed 24 August 2017].
[2] L. Nilsson, "EU exports and uptake of preferences: a first analysis" (2016) 50(2) *Journal of World Trade* 219.
[3] J. Yi, "Rules of Origin and the use of free trade agreements: a literature review" (2014) 9(1) *World Customs Journal* 43.

45 per cent of value of all the materials used in manufacturing the car had been imported from outside the EU or South Korea.

The more specific the RoO, the less the potential for trade deflection. However, this can come at a very high cost for businesses which require sophisticated accounting and documentation systems in order to assess whether their products qualify for the FTA's preferential treatment.

FTA compliance—the landscape for businesses

The ability of businesses to benefit from preferential treatment under an FTA is a key indicator of the extent of trade liberalisation achieved by that FTA. The assumption, however, that businesses will take advantage of FTAs is not necessarily correct. Businesses undertake a cost-benefit analysis to assess whether or not they will comply with RoO. The greater the size of the tariff preference, the greater the incentive to take advantage of the benefits offered by the FTA. However, if the difference between MFN tariffs and the preferential tariff afforded under the FTA is less than the cost of compliance, businesses are likely to ignore RoO. FTA utilisation is also linked to the volume of trade: the greater the volume, the smaller the impact of costs relating to RoO compliance.

RoO compliance requires producers and businesses to assign staff and resources to determine the origin of goods according to the RoO in the FTA and issue FTA certificates. For example, a 2005 study estimated that, with respect to the North American Free Trade Agreement (NAFTA), the price of Mexican apparel products increased by 12 per cent to compensate for the cost of complying with NAFTA's RoO.[4] Another 2006 study estimated the trade-weighted compliance costs at approximately 6.8 per cent for NAFTA.[5]

As a result, companies need to have in place efficient systems that track origin data across the entire supply chain. The responsibility of determining FTA origin and issuing FTA compliance certificates also needs to be allocated to specialists who are familiar with customs matters and who have regulatory expertise. Businesses need to find synergies across the industry to lessen costs and to benefit from technology that makes it more cost-effective to automate and improve origin determination processes.

According to EY's 2016 Global Trade Symposium report, trade executives of multi-national corporations reported the following approach: 38 per cent assigned dedicated internal resources to undertake preferential agreement work and 33 per cent used third parties to assist in the processes. Outsourced activities included "doing the operations work", "soliciting suppliers", "getting [vendor] certificates", and "qualification analyses". The overall consensus of these executives was that such strategic activities had a positive impact on the financial result of their companies.

Although multi-national corporations may be able to sustain such resource allocation, this is unlikely to be the case for small and medium-sized firms (SMEs). For these companies, pursuing FTA origin compliance activities may not be perceived as cost-justified. SMEs are more likely to focus on quality and price rather than complex customs specifications, and their staff may not be trained or experienced in customs matters to determine FTA origin qualification. As a result, SMEs may find it more difficult to compete for market share in the overall FTA zone and may be deterred, in general, from participating in international markets altogether.

FTA underutilisation and reforms

The difficulties RoO pose have been well recognised by different studies. These have found, by and large, that the restrictiveness, complexity, compliance costs and uncertainty arising from the administration of RoO are factors that have led to the under-utilisation of FTAs.[6] For each of these aspects (compliance, administration or complexity), different research methodologies have been devised, which has resulted in the creation of different measures of FTA utilisation. Policy-makers should consider all of these aspects to improve RoO and FTA utilisation in practice.

So far, reform efforts and proposals have focused on making RoO simpler, more transparent and predictable[7]; promoting convergence of rules across trade agreements, including harmonisation and standardisation of certification and verification procedures[8]; allowing for diagonal cumulation between countries that have all concluded agreements with each other[9]; liberalising RoO by lowering regional value content requirements[10]; and waiving RoO for low tariffs,[11] among others. However, such recommendations have often faced significant political opposition.

The proliferation of FTAs has also led to the so-called "spaghetti-bowl" effect, whereby multiple RoO arising from overlapping agreements add another layer of

[4] O. Cadot, C. Carrere, J. de Melo and A. Portugal-Perez, "Market access and welfare under free trade agreements: textiles under NAFTA" (2005) 19(3) *World Bank Economic Review* 379.
[5] O. Cadot C. Carrere, J. de Melo and B. Tumurchudur, "Product-specific rules of origin in EU and US preferential trading arrangements: an assessment" (2006) 5(2) *World Trade Review* 199.
[6] Yi, "Rules of Origin and the use of free trade agreements" (2014) 9(1) *World Customs Journal* 43.
[7] V.C. Jones and M.F. Martin, "International Trade: Rules of Origin", Congressional Research Service Report 7-5700, RL34524 (2012).
[8] A. Estevadeordal, K. Suominen, J.T. Harris and M. Shearer, "Bridging Regional Trade Agreements in the Americas" (New York: Inter-American Development Bank, 2009).
[9] R. Baldwin, "Multilaterilising Regionalism: Spaghetti Bowls as Building Blocs on the Path to Global Free Trade", *NBER Working Paper 12545* (2006).
[10] M. Mikic, "Preferential trade agreements and agricultural trade liberalization in Asia and the Pacific", *MPRA Paper No.2947* (2007).
[11] Productivity Commission, "Bilateral and Regional Trade Agreements, Research Report (Canberra: November 2010), *http://www.pc.gov.au/inquiries/completed/trade-agreements/report/trade-agreements-report.pdf* [Accessed 24 August 2017].

complexity businesses need to navigate. In designing RoO, governments will also need to consider their interconnection with RoO in other FTAs.

RoO are the gatekeepers of FTAs, they are both necessary and standard. However, in designing RoO, future analysis is necessary for governments to understand and mitigate the impact of the proposed design on the costs of administration and the compliance burdens imposed on different companies.

Conclusion

Global trade has had a transformative impact on businesses. The WTO estimates that by 2030 the import content of exports will rise to 60 per cent, compared with 40 per cent in 2012 and only 20 per cent in the 1990s. As goods continue to be traded several times across borders before the final product reaches consumers, RoO will evidently continue to play a significant role in strengthening, or restricting, trade liberalisation.

Given the current attitudes towards globalisation, the instruments that promote global trade need to ensure they provide a level playing-field. The benefits must be for all, not just for multi-national corporations. Reforms and recommendations that improve the design of RoO and simplify their administration in a politically feasible way will be crucial to ensure FTAs achieve their objectives.