Changing Rules of Origin to Improve Market Access for Least Developed Countries

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CGD Notes

Removing trade barriers lowers costs and expands trade, but rules of origin often penalize poor countries. What trade preferences give with one hand, they take away with the other.

Developed countries are committed by the Millennium Development Goals, and under the World Trade Organization (WTO) communiqué issued at the Hong Kong ministerial in 2005, to provide duty-free, quota-free (DFQF) market access for least developed countries (LDCs). Removing trade barriers to LDC exports lowers trade costs and expands trade, but rules of origin often raise costs and penalize exports, especially in LDCs with relatively undeveloped manufacturing sectors. As a result, what trade preferences give with one hand, they frequently take away with the other. While many rich countries have more to do to provide DFQF market access for LDCs, many could immediately improve existing programs by implementing more flexible rules of origin.

Are Rules of Origin Needed?

There are at least three potential rationales for having rules of origin in preferential trade arrangements:

1. To prevent "trade deflection," transshipping goods through a beneficiary country to take advantage of a preference for which the producing country is not eligible.

2. To protect import-competing industries by defining rules with difficult or costly stipulations, including requiring the use of inputs from the preference-giving country.

3. To stimulate the development of upstream industries in the preference-receiving country.

Only the first of these stands up to scrutiny. The second contradicts the purported objective of trade preferences and is hypocritical. The third is understandable in theory, but seldom works in practice, especially in smaller, poorer countries with limited productive capacity.

A Practical Solution

Aside from the direct impact of rules of origin, the complexity of preferential trade arrangements, with rules that differ widely from country to country and from trade agreement to trade agreement, raises transactions costs. Global harmonization around a system that is simpler, more transparent, and facilitates trade would be desirable, but many years of negotiation at the WTO have made only limited progress toward that goal. Moreover, the parameters of a model system are not entirely obvious. Rules based on setting a minimum value of local content or maximum value of imported content seem simple and transparent, but developing such a rule that is appropriate to most LDCs most of the time is difficult, especially given volatile exchange rates and commodity prices and other uncontrollable factors.

A more practical approach in the short run is "extended cumulation," which allows flexibility in meeting rules without changing the rules themselves. This approach allows beneficiaries to source inputs from a defined group of countries and still have the final product be considered eligible for preferential treatment. The key lies in defining a "cumulation zone" that is broad enough to permit efficient sourcing. Currently, most preference-granting countries

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allow only limited cumulation, bilaterally or within designated regions.

The proposal here is to allow LDCs to cumulate any input from other developing countries and from countries with free-trade agreements (FTAs) with the preference-granting country if those inputs would have entered duty-free had they been shipped directly from the FTA partner to the preference-granting country.[1] This definition of extended cumulation would correct, for example, the problems that Haiti faces with apparel exports. For many of those exports, Haiti is bound by U.S. rules of origin to use U.S. yarn and fabric (in a T-shirt, for example) to receive duty-free treatment. That same T-shirt, however, cannot enter duty-free into Canada because Canada's rules of origin for imports from Haiti do not allow for U.S.-sourced fabric, fabric which would receive duty-free treatment under NAFTA were it shipped directly from the United States to Canada. While Canada's rules of origin allow substantial flexibility, including cumulation from all beneficiaries under its General Preferential Tariff , extending the cumulation zone to its FTA partners would create the greatest opportunities for LDCs, including Haiti.

Extended cumulation is a practical approach to allow countries to flexibly meet rules of origin and reap the benefits of expanded market access.

Here is how extended cumulation would work for each of the major approaches to rules or origin.

Tariff shift

The tariff shift approach specifies the degree of the change in tariff categories that a product must undergo in a country to designate that country as the originator of a product. The rules usually define the shift at the chapter (2-digit), heading (4-digit), or sub-heading (6-digit) level, and they are fairly flexible if they are set at the more disaggregated sub-heading or heading levels. For rules set at higher levels of aggregation, extended cumulation would help give LDCs the flexibility they need to achieve the required change in tariff classification as materials originating within the extended cumulation zone could be used by the beneficiary country to meet the tariff shift.

Value content

Value content can be defined as either a minimum proportion of local content or a maximum share of imported content that will convey origin in the beneficiary country. Rules requiring high levels of local content can be difficult for LDCs with small manufacturing sectors to meet. Changing value content rules to allow content from countries in a designated cumulation zone would greatly ease the burden on LDCs.

Technical process

Many countries define specific processes that must be conducted in the beneficiary country for the final product to be eligible. Allowing extended cumulation of processes would ease eligibility for DFQF treatment. For example, changing the EU rule of origin for woven garments could allow the weaving of fabric to be cumulated from eligible countries and the cutting and sewing would to convey origin. The final product would have to be transformed in the beneficiary country; simple finishing processes, such as repackaging, would not be sufficient to convey origin, as in existing programs. De facto, this would make the EU rule similar to the U.S. rule under the African Growth and Opportunity Act.[2].

Advantages of Extended Cumulation

- It does not require harmonization of rules regimes and could be done quickly and unilaterally.
- It would encourage trade among developing countries.
- It could be used as a model for reforming rules of origin in reciprocal trade agreements.

1 This proposal is based on the discussion and recommendations in the report of the CGD working group. It is similar to, and inspired by, a proposal for extended cumulation by Jeremy T. Harris of the Inter-American Development Bank, but it is more specific because of the focus on LDCs. Harris' proposal was aimed at all developing countries participating in Generalized System of Preferences programs and followed the logic that beneficiaries should be able to cumulate "any materials that would enter the grantor country duty free if exported directly." The important point here is the emphasis on the scope of the cumulation zone. Limiting cumulation to the LDCs alone would be of little benefit, as they do not produce in sufficient quantity many of the materials and inputs needed.

2 The weaving would still have to be carried out within the defined cumulation zone.

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