APEC WORKSHOP ON BEST PRACTICES IN TRADE POLICY FOR RTAs/FTAs: PRACTICAL LESSONS AND EXPERIENCES FOR DEVELOPING ECONOMIES

Ha Noi, Viet Nam
27 February – 1 March 2006

APEC Committee on Trade and Investment
April 2006
AGENDA

Day 1: 27 February 2006

Morning Session

08:30 - 09:00 Registration of participants
Moderator Mr. TRAN Quoc Khanh, Director General, Multilateral Trade Policy Department, Ministry of Trade of Viet Nam.

09:00 - 09:15 Welcoming remarks by H.E. Mr. LUONG Van Tu, Deputy Minister, Ministry of Trade of Viet Nam

09:15 - 10:00 “WTO Rules on RTAs/FTAs from Perspective of Developing Countries”
Speaker: Prof. Robert Scollay, Coordinator of the Pacific Economic Cooperation Council (PECC); Associate Professor of the APEC Study Centre at the University of Auckland

10:00 - 10:15 Qs & As Session
10:15 - 10:30 Coffee Break.

10:30 - 11:30 “Methodologies for RTA/FTA Feasibility Studies”
Speaker: Prof. Robert Scollay, Coordinator of the Pacific Economic Cooperation Council (PECC); Associate Professor of the APEC Study Centre at the University of Auckland

11:30: - 12:00 Qs & As Session.
12:00 - 13:30 Lunch Break

Afternoon Session

Moderator: Prof. Robert Scollay
TRADE IN GOODS

13:30 - 14:15 “The Origin of Goods- Rule of Origin in Regional Trade Agreements”
Speaker: Mr. Antoni Estevadeordal, Principal Advisor, Integration and Regional Programs Department, Inter-American Development Bank, Washington, DC

14:15 - 14:30 Qs and As Session
14:30 - 14:45 Coffee Break

14:45 - 15:30 “Legal Frameworks for North-South RTAs under the WTO System”
Speaker: Ms. Akiko Yanai, Regional Integration Studies Group, Institute of Developing Economies (IDE), 3-2-2 Wakaba, Mihama-ku, Chiba, Japan

15:30 - 15:45 Qs and As Session

15:45 - 16:30 “Rules of Origin: Implementing Change- New Zealand Experience”
Speaker: Mr. Kit Kickey, Customs Authority of New Zealand

16:30 - 16:45 Qs & As Session

End of day 1

Evening Activities
18:30 - 20:00 Mr. TRAN Quoc Khanh, Director General, Multilateral Trade Policy Department, Ministry of Trade of Viet Nam.
Venue: The Ha Noi Horison Hotel, 40 Cat Linh Street.
All speakers and participants are warmly welcome to attend.
Dress code: Smart casual.

Day 2: 28 February 2006

Morning Session

Moderator: Mr. Antoni Estevadeordal

09:00 - 09:30 “Briefing and overall assessment of RTAs/FTAs cooperation in APEC so far. CTI’s workplan on RTAs/FTAs for 2006”
Speaker: Mr. Chris DeCure, CTI Chair of APEC.

09:30 - 09:45 Qs & As Session
TRADE IN SERVICES AND INVESTMENT

09:45 - 10:30: “Models for Services Negotiation in RTA/FTA: Options for Developing Countries”
Speaker: Mr. BUI Huy Son, Senior Economic Researcher, Viet Nam

10:30 - 10:45: Qs & As Session
10:45 - 11:00 Coffee break

11:00 - 12:00 “Services Liberalization by APEC Member Economies”
Speaker: Ms. Jane Drake-Brockman, Managing Director, Trade and Environment Solutions, Executive Director, Australian Services Roundtable
Dr. Sherry Stephenson, Coordinator, Services Expert Group, PECC Trade Forum Director, Department of Trade, Tourism and Competitiveness Organization of American States (OAS)
12:00 - 12:15 Qs & As Session
12:15 - 14:00 Lunch break

Afternoon Session

Moderator: Prof. Robert Scollay

14:00 - 14:45 “Negotiation of an Investment liberalization agreement under an RTA/FTA”
Speaker: Ms. Jane Drake-Brockman, Managing Director, Trade and Environment Solutions, Executive Director, Australian Services Roundtable

14:45 - 15:00 Qs & As Session

OTHER SPECIFIC RULES

15:00 - 15:45 “Labour Movement and International Trade”
Speaker: Mr. Roman Grynberg
Adviser & Head, Economic Affairs Division - International Trade & Regional Cooperation Section, Commonwealth Secretariat

15:45 - 16:00 Qs & As Session
16:00 - 16:15 Coffee Break

Speaker: Ms Qalo Veniana, Commonwealth Secretariat

16:45 - 17:00 Qs & As Session

End of day 2

Day 3: 01 March 2006

Morning session

Afternoon Session

Moderator: Mr. Roman Grynberg
09:00 - 09:45: “The treatment of agriculture in regional trade agreements”
Speaker: Dr.. Sherry Stephenson
Coordinator, Services Expert Group, PECC Trade Forum
Director, Department of Trade, Tourism and Competitiveness Organization of American States (OAS)
09:45 - 10:00: Qs & As Session
10:00 - 10:15: Coffee Break

FTAs/RTAs STORIES FROM SPECIFIC COUNTRY’S PERSPECTIVES

10:15 - 10:45: “Lessons and Experiences of Mexico in dealing with issues emerging from RTAs/FTAs participation”
Speaker: Mr. José Guadalupe Sáenz Solís
Director General for Trade Policy
Ministry of Economy, Mexico

10:45 - 11:15: “Lessons and Experiences of Australia in dealing with issues emerging from RTAs/FTAs participation”
Speaker: Ms. Jane Drake-Brockman, Managing Director, Trade and Environment Solutions, Executive Director, Australian Services Roundtable.

11:15 - 11:45: “Vietnam’s participation in ASEAN Free Trade Area: Lessons and Experiences”
Speaker: Mr. BUI Huy Son, Senior Economic Researcher, Viet Nam

11:45 - 12:00: Qs & As Session

12:00 - 12:30 “Free Trade and Customs Union Agreements: Experience of the Russian Federation”

12:30-12.45 Conclusions and closing remarks by Viet Nam
Mr. TRAN Quoc Khanh, Director General, Multilateral Trade Policy Department, Ministry of Trade of Viet Nam.

12:45 Lunch

END
WELCOMING REMARK BY H.E.MR. LUONG VAN TU
Deputy Minister of Trade
at
APEC Workshop on Best Practices in Trade Policy for RTAs/FTAs:
Practical Lessons and Experiences for Developing Economies

27th Feb– 1st March 2006
Ha Noi Horizon Hotel
Ha Noi, Viet Nam

Distinguished guests,
Ladies and Gentlemen,

At the outset, I would like to express my warm welcome to all of participants to “APEC Workshop on Best Practices in Trade Policy for RTAs/FTAs: Practical Lessons and Experiences for Developing Economies” held from Feb 27 through 1st March 2006 in Ha Noi Horizon Hotel. Your interest and consideration, especially those of you have traveled a long way to join us today are mostly appreciated.

As you know, although encouraging progresses have been obtained, especially in agricultural subsidies, so far the multilateral rounds of trade liberalization (Doha Round) has still been impeded by various issues where countries could not arrive at a common stand and thus, could not be finished as scheduled on 1 January 2005. This fact is really a stumbling-block to global integration process. Under this circumstance, many countries have turn to regional trade arrangements/ free trade agreements (RTAs/ FTAs) as a way to find new market opportunities, expand their trade and economic relations, attract more investment for economic development. Therefore, it is no wonder as this special form of trade relation is enjoying a boom and recognized as an irrevocable trend in international trade.

Also in APEC framework, RTAs/ FTAs have been a focus for cooperation, especially in the coming time. The 13th APEC Economic Leaders' Meeting in Busan, Korea in 2005 put a high note on this priority by endorsing the Busan Roadmap to the Bogor Goals, of which promotion of High-Quality Regional Trade Agreements and Free Trade Agreements (RTAs/FTAs) was highlighted. Our Leaders also welcomed the APEC Trade Facilitation Model Measures for RTAs/FTAs that would serve as a meaningful reference for negotiating RTAs/FTAs, and called for the development of model measures for as many commonly accepted FTA chapters as possible by 2008.

As a cooperation forum for 21 economies around Asia-Pacific rim, APEC is a unified community of diversified economic development as well as cultural and political identities. In order to realize a regional Community, APEC has attached priority to strengthening capacity of its developing member economies, as one of three main pillars of cooperation. This is a strongpoint, distinguishing APEC over other forums. In this connection, the support in
capacity building and information sharing concerning RTA/FTA negotiations are of great importance for developing members in realizing Bogor goals.

Bearing that in mind, this Workshop will be a good chance for participants from APEC economies to exchange views with competent experts on the policy-making process for RTAs/FTAs. I sincerely hope invaluable knowledge obtained at the Workshop will help participants, especially those from developing APEC members, in securing the best benefit from trade liberalization process and mitigate possible negative impact of RTAs/FTAs to economies.

On this occasion, I would like to express sincere thanks to APEC experts for their enthusiastic cooperation at this Workshop. My thanks also go to APEC Secretariat for their support to Viet Nam in organizing this Workshop as well as in other activities in APEC year 2006.

I wish you all fruitful discussion at the Workshop and a pleasant stay in Hanoi.

Thank you for your attention.
WTO Rules on RTAs/FTAs from Perspective of Developing Countries

Robert Scollay
APEC Study Centre,
University of Auckland
and
PECC Trade Forum
Provisions in Modern RTAs/FTAs

- Subject to WTO Rules on RTAs/FTAs
  - Trade in Goods
    - GATT Article XXIV
    - Enabling Clause of 1979
  - Trade in Services
    - GATS Article V
- Potentially within Scope of WTO Rules on RTAs/FTAs
  - Trade Remedies
  - SPS and TBT
- Not Regulated by WTO Rules on RTAs/FTAs
  - Investment
  - Competition policy
  - Government procurement
  - Intellectual Property
  - Labour and Environmental Standards
  - Dispute Settlement
WTO Rules on Trade in Goods

- Rules for developing countries differ according to status of partner
  - Developing country partner
    - Enabling Clause available
      (common)
  - Developed country partner
    - GATT Article XXIV must apply
      (increasingly common)
Enabling Clause

- RTAs/FTAs between developing countries
  - Limited exchange of preferences permitted
    - Partial tariff reductions
    - Limited product coverage ("positive list")

- Non-discriminatory non-reciprocal preferences by developed countries in favour of
  - all developing countries (GSP)
  - all least developed countries (e.g. EU’s EBA)
  - unique groups of developing countries (AGOA? US and EU Andean Preferences)

Other non-reciprocal preferences require a waiver
(e.g. Cotonou Agreement, CBI)
format must be FTA or CU
prohibition against raising barriers to non-members
- interpretation issue for customs unions
preferences must be reciprocal
requires elimination of
- tariffs on “substantially all the trade” (SAT) between the parties
- other restrictive regulations of commerce
implementation with a “reasonable period of time”
no specific provisions on
- special and differential treatment
- flexibilities for developing countries
Role of CRTA
GATT Article XXIV (2)

“Substantially all trade”
- no definitive rule or agreed definition
- possibilities include
  - percentage of tariff lines (95% at HS 6-digit level?)
  - percentage of trade (85%? 90%?)
    - actual v. potential trade
  - non-exclusion of entire sectors
- scope for flexibility
  - openness to interpretation
  - asymmetry possible eg in North-South agreements
  - key is perception of likeihood of challenge
- economic implications can vary
  - exclusion of competitive sectors may limit trade creation
  - exclusion of non-competitive sectors may limit trade diversion
GATT Article XXIV (3)

Transition periods

- Article XXIV: “reasonable period of time”
- 1994 Understanding: 10 years unless there are “exceptional circumstances”
- current practice
  - up to 20 years in North-South agreements
  - up to 18 years in North-North agreements
GATT Article XXIV (4)

Trade-off between coverage and flexibility
- older agreements often have substantial exclusions
- newer agreements often have more complete coverage (100% in some cases) balanced by facilitation of adjustment through
  - longer transition periods
  - use of tariff-rate quotas (TRQs), special safeguards (SSG), bilateral emergency actions (BEA)
- question: whether permanent availability of SSG or TRQ (usually with “continuous expansion”) counts as exclusion for SAT purposes?
Rules of Origin (ROO)

- crucial to liberalising effects of RTAs/FTAs
- may be trade-restrictive or trade-facilitating
- degree of restrictiveness determines offset to liberalising effect of tariff reductions
- effects tend to be non-transparent
- preferential v. non-preferential ROO
  - Uruguay Round mandated negotiation of agreement on non-preferential ROO (via WTO and WCO)
  - no rules exist on preferential ROO
- “spaghetti bowl” concerns
  - potential problems for exporters in economies involved in multiple RTA/FTAs with inconsistent ROO
Trade Remedies
(anti-dumping and safeguards)

- various approaches
  - prohibition of AD in some FTAs (rare)
  - modification of WTO provisions (e.g. increased ‘de minimis’)
  - WTO provisions left fully intact
- differing views on implications of prohibitions or modification of WTO provisions
  - enhancing liberalisation
  - discrimination
    (note: harmonisation of standards between RTA/FTA members might also be argued to be discriminatory)
  - modification of WTO provisions seems to be associated with less frequent use of AD actions
- controversy over whether FTA partners can be exempted from multilateral safeguard actions
Prospect of Changes to WTO Rules on RTAs/FTAs

- possibility of changes to WTO rules on RTAs/FTAs included in DDA agenda
  (part of “rules” negotiations)
- significant changes widely viewed as unlikely
  - “glass house” syndrome
  - conflicting objectives
    - relaxation v. strengthening
- provisions for improved transparency more likely
WTO Rules on Trade in Services

- GATS Article V provides rules for agreements for services liberalisation “between or among” parties to the agreement
- no Enabling Clause for services
- flexibility for developing countries provided within GATS Article V
GATS Article V (1)

- requires “substantial sectoral coverage”
  - relates to number of sectors, volume of trade affected
  - no *a priori* exclusion of any mode of supply
  - in sectors covered
    - absence or elimination of “substantially all discrimination” (in the sense of national treatment) via
      - elimination of existing discriminatory measures
      - prohibition of new or more discriminatory measures
    - allows consideration to relationship to “wider process of integration”

- prohibition on raising barriers to non-members
- GATS procedures must be followed if agreement leads to withdrawal or modification of commitments under GATS schedule
GATS Article V (2)

- **flexibility for developing countries**
  - no distinction between North-South and South-South agreements
  - flexibility for developing countries
    - in accordance with level of development
      - overall and in individual sectors and subsectors
    - applies to both sectoral coverage and absence/elimination of discrimination (especially the latter)
  - in practice allows wide latitude to developing countries
Relation to GATS Provisions

- Agreement provisions may involve modifications of standard GATS provisions

  e.g.
  - clearer and/or broader definitions of services “supplied in exercise of government authority”
  - inclusion of appropriate safeguard provisions
  - provisions strengthening or weakening restricted application to government procurement
  - provisions for review of commitments
Relation to Investment Provisions in RTAs/FTAs

- Mode 3 commitments involve liberalisation of foreign direct investment ("pre-establishment" commitments)
- wide variations in investment provisions of RTAs/FTAs
  - some limited to post-establishment
    - investor protection, rights and obligations of host/home countries and investors/investments
    - post establishment commitments and limitations on post-establishment commitments will typically apply to services sectors as well as non-services sectors
  - others may include pre-establishment
    - typically services sectors will be excluded from pre-establishment commitments in investment provisions
      - avoids overlap with Mode 3
Methodologies for RTA/FTA Feasibility Studies

Robert Scollay
APEC Study Centre,
University of Auckland and
PECC Trade Forum
Motivations

- Develop RTA/FTA Strategy
  - identify priority partners
    - market opportunities
    - defensive interests

- Responding to/initiating proposals
  - bilateral
  - plurilateral
Resource Issues

- **In-house or outsource?**
  - Assess in-house capacity
    - number of staff
    - expertise
    - experience
    - time availability
  - Assess external research providers
    - staff, resources and expertise
    - experience, track record
    - ability to address country-specific issues
Data Requirements

- **National**
  - trade data
  - tariff schedules
  - common level of disaggregation
  - spreadsheet format

- **Internationally comparable (e.g. Comtrade)**
  - allowing analysis of national and foreign trade data on same basis

- **Partner**
  - tariff schedules
  - reconciliation of discrepancies in national datasets
Research Techniques
Trade and Economic Indicators (1)

- Revealed Comparative Advantage
- Export Indicators
  - major export categories
  - export specialisation
  - export similarity
  - export complementarity
- Trade intensity
  - exports, imports
- Intra-industry trade index
- GDP and Growth Rates
- Economic characteristics
- Trends over time important
Research Techniques
Trade and Economic Indicators (2)

• Questions to be answered using trade indicators
  – potential for mutually beneficial inter-industry trade
  – potential for intra-industry trade
  – identify unfulfilled potential
  – identify largest, most dynamic markets
  – identify most dynamic export products
  – trends in relative competitiveness
Research Techniques Modelling

- Backward-looking (ex post)
  - gravity models
  - other econometric techniques

- Forward-looking (ex ante)
  - computable general equilibrium (CGE)

(ex post analysis can assist ex ante analysis)
Research Techniques
Partial Equilibrium (PE) v. General Equilibrium (GE)

- **Partial Equilibrium**
  - focus on one sector at a time
  - ignore interactions between markets
  - advantages: simple, transparent, intuitive
  - useful if “knock-on” effects likely to be small

- **General Equilibrium**
  - Takes account of linkages between markets
    - **Product**
      - complements and substitutes
      - inputs and outputs
    - **Factor**
      - land, labour, capital
    - **Domestic and foreign**
Research Techniques
Partial Equilibrium (PE) v. General Equilibrium (GE)

PE example: removal of tariff on wheat

P (wheat) falls

D (wheat) up (price elasticity)
Q (wheat) down (supply elastic)
M (wheat) up
Research Techniques
Partial Equilibrium (PE) v. General Equilibrium (GE)

GE example: removal of tariff on wheat

- P (wheat) falls
- D (wheat) up (price elasticity)
- D (butter) up (degree of complementarity)
- D (rice) down (elasticity of substitution)
- Q (wheat) down (elasticity of supply)
- Land, capital, labour out of wheat into butter
- M (wheat) up
Research Techniques
CGE in Trade Policy Analysis (1)

- Model based on detailed input-output tables
  - production relationships between sectors
  - factor inputs
  - import and export flows by sector
  - computers used to process massive amounts of data
- Standard demand and supply functions
- Trade barriers
- GTAP the most widely used version of CGE
  - 57 commodity group, 87 countries/regions
    - Usually reduced to manageable numbers
    - Heavy emphasis on agricultural sectors
  - global database, 2001 base year
  - standard modelling framework
Research Techniques
CGE in Trade Policy Analysis (2)

- **RTAs/FTA Simulations**
  - Set trade barriers to zero between partners
  - Re-run the model to produce estimates of
    - changes in economic welfare (is the economy better or worse off, and by how much? Changes caused by changes in efficiency or terms of trade?)
    - changes in production by sector
    - changes in imports and exports by sector and by partner
  - Ideal for
    - comparing likely effects of different possible RTA/FTAs
    - comparing different scenarios (e.g. agriculture included/excluded, other agreements initiated simultaneously)
  - Can be problematic as prediction of effects of a single RTA/FTA
    - wide range of possible assumptions and adjustments can affect the results
Research Techniques
CGE in Trade Policy Analysis (3)

- **Basic approach**
  - comparative static (compares “before” and “after”)
    - no provision for investment, productivity effects
  - competitive markets (“perfect competition”)
  - fully employed resources

- **Possible Enhancements**
  - dynamic setting
    - allows for investment and productivity effects
  - imperfect competition
  - adjust elasticities
  - more disaggregated treatment of labour markets
  - adjust baseline for subsequent changes
Research Techniques
CGE in Trade Policy Analysis (4)

- Some Limitations
  - drawbacks of basic approach
    - numbers often embarrassingly small
    - lacks time dimension
  - enhancements/adjustments can produce larger numbers but validity becomes difficult to assess
  - inadequate treatment of services
    - usually modelled as single sector
    - no detailed information on trade barriers
  - lack of connection to financial markets
Evaluating a Proposed RTA/FTA (1)

● **Initial Analysis**
  - know economy of partner
  - know and understand bilateral trade data
  - understand scope of potential preferences/concessions
    ● requires analysis of tariff schedules
  - possible use of CGE analysis
    ● identify location (sectors) of main production and trade effects
    ● assess potential effects of expected partner demands (e.g. exclusion of agriculture)
Research Techniques
CGE in Trade Policy Analysis (2)

● Consultative Phase
  – Government agencies
    ● revenue, customs, standards, and other regulatory issues, links to domestic policy (e.g. agriculture, industry)
  – Private Sector (import-competing and exporting firms, industry associations, chambers of commerce)
    ● Major competitive threats to domestic industry
      – economic and social implications
    ● Obstacles to export expansion
      – e.g. SPS, TBT, customs issues, transportation and other infrastructure problems etc
  – Rules of origin
    ● Crucial to liberalising effect
    ● Analyse implications of rules in partner’s existing RTAs/FTA, other FTAs
      – Private and public sector consultations
      – Importance of developing expertise
Special Issues Relating to Services

- Data Problems
- Rationale for Liberalisation
  - entry of foreign providers improves efficiency via increased competition and technology transfer
  - choose sectors for liberalisation accordingly
- Nature of Trade Barriers
  - liberalisation involves commitment to regulations consistent with market access and national treatment
    - importance of
      - ‘right’ regulatory framework as basis for commitment
      - identifying limitations needed to support ‘right’ framework and preserve necessary “policy space”
    - Implies need for
      - Inventory of existing regulatory measures
      - Regulatory reform as prerequisite for liberalisation in some sectors
Management Issues in Feasibility Studies

- **Key Steps**
  - organise roundtable of officials
  - identify and manage stakeholder participation
  - secure authority
  - determine management structure and resources
    - in-house v. outsourcing a key decision
  - ensure terms of reference are clear
  - set timelines
  - provide for monitoring/review at each “milestone” in the timeline
  - consider outputs as possible inputs to negotiations
    - Eg domestic sensitivities, export impediments, revenue implications
Rules of Origin (RoO) are among the most important instruments in the negotiation and functioning of Regional Trade Agreements (RTAs). Although they remain the subject of many newspaper headlines, they are designed to determine the eligibility of goods for preferential treatment among RTA members. Ostensibly meant to prevent the shipment of imported products across RTA borders after only superficial assembly, they are in practice as complex and opaque trade barriers. This book provides evidence strongly suggesting that they do so by intent rather than accidentally—in other words, that RoOs are truly trade policy instruments.

Beyond the collection of new evidence and its interpretation in light of recent theory, the book’s overall message for the policy community is that RoOs are a potentially powerful and new barrier to trade. Rather than being relegated to closed-door technical meetings, they should hold center-stage in trade negotiations.

‘One cannot understand today’s multilateral trading system without understanding its web of Preferential Trade Agreements. And one cannot understand these agreements without understanding their Rules of Origin.’ This collection of original theoretical and empirical papers sheds considerable light on what may well be the most important instrument of trade policy of our times.

‘Rules of Origin are among the least understood and most important elements of free trade agreements. This well-organized study presents both a technical and political analysis of their uses and impacts and is a “must read” for anyone responsible for developing, negotiating, or implementing these rules.’

Carla A. Hills, Former US Trade Representative

'This book by some of the world’s leading experts in the field is a state-of-the-art analysis of a complex and oft-neglected aspect of trade policy. With the growth of regionalism, rules of Origin become more significant by the day, yet remain poorly understood. The present work goes a long way in remedying this deficiency. It comprises an entire blend of economic theory and empirical study, together with political economy and development analysis.

Patrick Low, Director, Economic Research and Statistics, WTO Secretariat

‘Preferential trading arrangements are an increasingly important part of the international trade landscape. A careful analysis, both theoretical and empirical, of their structure and effects is badly needed. Rules of Origin are a central feature of PTAs, and their use likely determines the effects of PTAs. This volume represents a significant contribution to our understanding of RoOs and their effects.’

Anne Krueger, First Deputy Managing Director, International Monetary Fund

This book is the product of a research project generously sponsored by the Integration and Regional Programs Department of the Inter-American Development Bank.
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Introduction

Olivier Cadot, Antoni Estevadeordal, Akiko Suwa, and Thierry Verdier

The spread of Preferential Trading Arrangements (PTAs) is rapidly altering the multilateral system created at Bretton Woods. The WTO reckons that if the sixty PTAs currently under negotiation are eventually formed, there will be in total twice as many of them as there are WTO members.\(^1\) Just by themselves, the EU’s future Economic Partnership Agreements\(^2\) with ACP countries will cover over half of the WTO’s membership. Seen from a different angle, the World Bank estimates that roughly one third of world trade takes place, at least nominally, on a preferential basis (World Bank 2005).\(^3\) As encroachments to the MFN principle have multiplied—whether covered by GATT Article XXIV\(^4\) or by particular waivers such as the one secured by the EU to cover the Cotonou Convention—new rules have gained prominence, among which those used to confer originating status to preferential exports, so-called Rules of Origin (RoOs).

The rise of regionalism has far-reaching implications not just for the multilateral trading system’s philosophy but also for the day-to-day conduct of business. For good or for bad, preferential trading rules are of

\(^1\) Two hundred and fifty-four PTAs have been notified so far, 124 to the GATT prior to 1994 and 130 to the WTO since 1995. In 2005, an estimated 300 will be in force. It should be kept in mind, however, that many of these agreements are essentially empty shells.

\(^2\) The Economic Partnership Agreements (EPAs) currently under negotiation between the EU and the 77 African, Caribbean and Pacific (ACP) countries will replace the current Cotonou Convention (itself the successor of the Lomé Conventions) by end 2007. They will involve, inter alia, replacing the EU’s unilateral preferences by a GATT-consistent free-trade zone.

\(^3\) The proportion, however, drops to about 20\% if one takes out lines for which MFN tariffs are zero.

\(^4\) GATT Article XXIV allows WTO members to eliminate tariffs on a preferential basis provided that they do not simultaneously raise them against non-members and that ‘substantially all trade’ between preferential trading partners is liberalized, i.e. that they form a genuine free-trade area.
increasing relevance to traders on the ground.\textsuperscript{5} To take but one example, a Mauritian garment today enjoys an average tariff preference of 11.9\% on the European market provided that its originating status can be established. On the one hand, in a commodity sector this can mean a substantial cost advantage over MFN competitors. Moreover, tariff-free status combined with export-processing zone treatment in the source country speeds up customs clearance, adding to the cost advantage a time element that can prove critical in the garment industry’s intense time-based competition. On the other hand, however, if RoOs impose the use of expensive local materials and burdensome administrative procedures to confer originating status, they can also render the preference margin worthless.

Thus, notwithstanding the classic debate about whether PTAs are good or bad for world welfare (i.e. whether they generate ‘trade diversion’ or ‘trade creation’), how they are designed matters a lot if one is to understand how much market access they really confer. This is particularly important in view of the developmental justification often put forward in favor of North-South PTAs such as the United States’ Africa Growth & Opportunity Act (AGOA) or the EU’s Everything But Arms (EBA) initiative.

In parallel to the rise of preferential agreements, world trade has also been transformed by the rise of so-called ‘vertical trade’. Anecdotal evidence supported by case studies\textsuperscript{6} suggests that multinational companies have, over the last three decades, set up in many sectors and regions what Gordon Hanson called ‘regional production networks’, involving extensive outsourcing and the use of cross-border supply chains. Lesotho’s garment industry, whose exports to the US have boomed at an annual rate of about 30\% per year since the mid-1990s, is a case in point. Over 90\% of Lesotho’s exporting factories are owned and managed by East Asian nationals. They get large orders from US brands placed through company headquarters in Asia and use inputs provided by the parent companies in so-called CMT (‘cut, make and trim’) operations. A similar process, albeit on a less spectacular scale, is visible elsewhere in the world and provides much-needed employment for impoverished populations (in particular women in the case of the garment industry).\textsuperscript{7} Overall Hummels \textit{et al.}\textsuperscript{8}

\textsuperscript{5} See the EU Commission’s \textit{Green Paper on Rules of Origin in preferential agreements} (CEC 2003) and part II of UNCTAD’s report on trade preferences for LDCs (UNCTAD 2003).


\textsuperscript{7} Kenyan cut-flower exports to the EU have similarly boomed from $54 m to $139 m between 1997 and 2002. Early empirical studies (e.g. Feenstra and Hanson 1996, or Campa and Goldberg 1997) provided indirect evidence of these trends. Systematic statistical evidence of ‘vertical trade’ has been slower to emerge, as the necessary combination of trade and input-output data has become available only recently.
(2001) estimate that ‘vertical specialization accounts for up to 30% of world exports and has grown as much as 40% in the last twenty-five years’ (p. 1).

Depending on their design, PTAs have the power to boost or hamper the development of these regional production networks. On the one hand, the experiences of Mauritius under Lomé and parts of sub-Saharan Africa under AGOA show that trade preferences can foster the emergence of North–South supply chains, in particular in the Textile and Apparel (T&A) sector (Table 1). On the other hand, stringent RoOs can prevent the smooth operation of these cross-border chains or foster the emergence of inefficient ones.

This volume brings together theoretical and empirical contributions to our understanding of how preferential RoOs affect trade flows and outsourcing decisions, how they vary across PTAs, why their legal form matters, and what political-economy forces shape them.

1. Theoretical perspectives

Pioneered by Grossman (1981), the formal analysis of local-content protection is fairly recent, because it must draw on models of multistage production that are necessarily somewhat complex. In the simplest possible setting, the combined effects of RoOs and tariff preferences on market access for the Southern partner of an FTA can be understood with

Table 1 Textile & Apparel exports under AGOA

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<tr>
<td></td>
<td>1997</td>
<td>2003</td>
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<tr>
<td>Kenya</td>
<td>31.3</td>
<td>187.8</td>
<td>94</td>
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<tr>
<td>Lesotho</td>
<td>86.5</td>
<td>392.4</td>
<td>95</td>
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<tr>
<td>Mauritius</td>
<td>184.4</td>
<td>269.0</td>
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<td>South Africa</td>
<td>70.9</td>
<td>231.8</td>
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8 Grossman (1982) studied so-called ‘Offshore Assembly Provisions’ (OAP) that, as their name indicates, grant special trade treatment to goods assembled offshore usually by domestic firms. The European Union for a while granted similar treatment to limited quantities of goods assembled in Central and Eastern Europe under the name of ‘Outward Processing Treatment’ (OPT) quotas. OAP and OPT have economic effects that are quite similar to those of Rules of Origin. 9 The early work here is by Dixit and Grossman (1982).
the help of the four-quadrant diagram in Fig. 1. Consider a North-South FTA in which the South assembles shirts ($Y$) by combining value added ($V$) with cotton ($X$). The latter can be imported from either the Northern partner or the Rest of the World (ROW). The South does not produce cotton, whereas the North produces and protects both shirts and cotton, being import-competitng in both sectors. Let $x$ and $x^*$ denote the South’s use of Northern and ROW cotton respectively, so $x + x^* = X$. Southern shirt technology is Leontief with a unit input-output coefficient, i.e. $Y = \min\{V, X\}$. In words, one shirt is made with unit of value added and one of cotton.

Value added is remunerated with what is left of sales revenue after subtracting the cost of cotton. Let $P^*$ be the world price of a shirt and $p^*$ that of a unit of cotton. At free trade, the ‘net price’ of a shirt (what is available to remunerate value added) is $\eta = P^* - p^*$. Let $P$ and $p$ be the domestic (intra-FTA) prices of shirts and cotton, respectively, and $\eta = P - p$ be the variable measured on the vertical axis of Fig. 1. Southern value added (or equivalently shirt output, as the two are by construction equal) is measured on the RHS’s horizontal axis, and the curve in the first quadrant is the South’s supply of value added (or, equivalently, of shirts).

Moving around clockwise, the induced demand for cotton is shown in the second quadrant as a 45° line (since $Y = X$ with a unit input-output coefficient). The vertical axis pointing downward thus measures the South’s total cotton demand, from the US and from the ROW. With $p$, the
price of cotton, measured on the LHS’s horizontal axis (pointing leftward), the curve in the third quadrant is the Northern supply of cotton. The quantity of Northern cotton bought by the South is just what the North can offer at world price \( p^* \), \( x^*(p^*) \), the rest being procured in the ROW. The proportion \( x^*(p^*)/X \), which we will call \( r^* \) later on, is the South’s desired regional value content.

The diagram is closed in the fourth quadrant by a line mapping the cotton price \( p \) into a net price \( \eta \). To understand how it is constructed, start counterclockwise from the vertical axis by setting \( P = P^*/C_3 \) and \( p = 0 \). The net price is then \( \eta = P^* \). Then raise \( p \), i.e. slide to the left along the horizontal axis. As \( p \) goes up, the net price \( \eta \) goes down one-for-one, hence the downward-sloping line with slope \(-1\) in the fourth quadrant. The line hits the horizontal axis when \( p = P^* \).

The effect of tariff preferences in this diagram is straightforward (Fig. 2). Suppose that the price at which Southern shirt makers can sell in the North is now \( P = P^* + \delta \), where \( \delta \) is the difference between the North’s MFN and preferential tariffs (the preference margin). The net price goes up by the amount of the tariff preference \( (\eta = P - P^*, \text{ so } \Delta \eta = \delta) \) and the total demand for cotton goes up one-for-one with the supply of shirts. However, all the additional demand goes to ROW cotton, the price and supply of Northern cotton being unchanged at \( p^* \). The slope of the dotted line in

![Fig. 2 The effect of tariff preferences.](image-url)
the second quadrant gives the desired regional value content $r^*$, which has gone down as total cotton demand has gone up whereas local sourcing is unchanged. The hatched area in the first quadrant is the effect of the tariff preference on Southern producer surplus.

In this setting, a Regional Value Content (RVC), a particular form of RoO, can serve as a vehicle to force some of the additional cotton demand toward Northern suppliers (Fig. 3). Consider a new dotted line in the second quadrant with a slope $-r$ that is steeper than that of the ‘desired’ one ($r^*$). The 45° line would imply a 100% RVC, so rotating the dotted line clockwise (making it steeper) implies a more stringent RVC.

The action is now in the third quadrant, where the induced demand for Northern cotton forced by the RVC must be met at a higher domestic price $p$. The hatched area in that quadrant gives the additional producer surplus generated in the cotton sector by the RVC imposed in the downstream shirt sector. Abusing notation, take now the price of cotton used in the construction of the net price $\eta$ on the vertical axis as the average price of the ‘composite’ cotton used by Southern producers, i.e. $\bar{p} = np + (1-r)p^*$. Thus $\eta = P - \bar{p}$, and the slope of $\eta$ in terms of $p$ is now $-r$ (measured leftward as before), at least as long as the RVC is binding, i.e. whenever $p > p^*$. This gives the line that closes the diagram.

![Diagram](image)

**Fig. 3** Tariff preferences and RoO combined.
The interest of the diagram is that it highlights the RVC’s twin effects: (i) partly offsetting the positive effect of tariff preferences on Southern producer surplus (see the reduction of the first quadrant’s hatched area from Fig. 2 to Fig. 3); (ii) raising the surplus of upstream Northern producers (hatched area in the third quadrant of Fig. 3). In the extreme, the reduction in Southern producer surplus can eat up the whole benefit of tariff preferences, as indicated by the dotted ‘participation constraint’ line in Figs. 2 and 3.

At that point, as explained by Kala Krishna in the first chapter, a regime switch takes place and strange things happen. Drawing on her previous work with Jiandong Ju (Ju and Krishna 2002), she shows that as long as RoOs are not overly strict, tightening them raises the captive demand for local intermediates and hence their prices, as shown in Figs. 1–3. However when they become so strict as to make firms indifferent between using the preferential regime (tariff preferences cum RoO) or shipping under the MFN regime, tightening RoOs further reduces the number of exporters using the preferential regime and hence the price of intermediates, resulting in higher, not lower, imports. In her exhaustive survey of the analytics of RoOs, she also highlights several important theoretical laws; for instance the fact that they can shelter losers from the competitive effects of intrabloc trade. Relatedly, she argues that the formulae upon which RoOs are based can make large differences on their impact.

Matthias Thoenig and Thierry Verdier explore new territory with a game-theoretic analysis of the effect of RoOs on the outsourcing/relocation decisions of multinational companies, an issue that, as mentioned earlier, is at the heart of recent trends in international trade. Their analysis of strategic outsourcing is closely related to the classic industrial-organization literature on capacity investment. Using a model with a continuum of production stages a la Dixit–Grossman (1982), some or all of which can be outsourced, they show that competition induces oligopolistic firms to outsource too much from the point of view of their collective optimality. By putting mandatory limits on the proportion of

\[^{10}\text{This point was initially made by Krueger (1993), who noted that RoOs can ‘export’ trade protection from most to least protectionist FTA members. Cadot et al. (2001) also showed that RoOs segment the internal market of FTAs by preventing trans-shipment (and showed, incidentally, that they make it possible to generate welfare gains by selectively liberalizing member-state markets).}\]

\[^{11}\text{Their legal form seems sometimes strikingly fine tuned to suit special interests. Brenton and Imagawa (forthcoming) note a particularly egregious case in which NAFTA’s RoO for certain clothing products specifies that imported fabric must be ‘of subheading 511111 or 511119, if hand-woven, with a loom width of less than 76 cm, woven in the United Kingdom in accordance with the rules and regulations of the Harris Tweed Association, Ltd, and so certified by the Association.’ (p. 20)}\]
Rules of Origin in the world trading system

the value chain that can be outsourced, RoOs can then act as commitment devices taking the oligopolists closer to their collusive solution. Good for them but not so, of course, for consumers. Thoenig and Verdier also show, interestingly, that in a world of incomplete contracts, RoOs can do some good by overcoming opportunism in subcontractor–client relationships.

2. The complexity of RoOs

Antoni Estevadeordal and Kati Suominen provide in chapter three a map guiding the reader through the maze of different RoOs. The difficulty of assessing the degree of stringency of this growing maze of rules explains, in part, the lack of solid empirical analysis on the economic effects of RoOs. One key distinction they make is between product-specific Rules of Origin (PSROs) and regime-wide rules. Prominent among the latter are ‘cumulation’ rules allowing the treatment of inputs from other PTA partners as originating. As for the former, they take myriad different forms.\(^\text{12}\) A typical one is to require that the transformed good belong to a different tariff line or grouping than its imported inputs, but technical requirements, exceptions and so forth are plenty.\(^\text{13}\) Estevadeordal and Suominen are able to compare the stringency of PSROs across PTAs by building on an index of PSRO restrictiveness first developed in Estevadeordal (2000) and based on a few simple classification principles.

Several observations emerge from their analysis. First and perhaps particularly strikingly, those PTAs that involve some of the most substantial intraregional trade flows, such as NAFTA and the EU’s FTAs also tend to

\(^{12}\) NAFTA’s product-specific RoOs are so complex that Annex 301, where they are described, is over 300 pages long, whereas the Agreement itself is less than fifteen pages. The European Union’s Single List of RoOs, which applies to all its preferential trade agreements (in order to make them compatible so that cumulation rules can be applied between all of them) is also quite complex. By contrast, some agreements, like the Latin American Integration Agreement (LAIA) or South & East Africa’s COMESA, have simple rules applying across the board. AGOA is in the middle, with a uniform local-value-content requirement but very stiff yarn-forward rules applying to textiles and apparel (where they matter).

\(^{13}\) Exceptions are often used to make RoOs selectively stringent in order to protect special interests. For instance, in her contribution to this volume Krishna cites a rule of origin of the Canada-US FTA on aged cheese according to which fresh milk is not an input conferring origin. Other examples are numerous. For instance, the EU’s Single List confers origin to biscuits made of imported materials from any chapter except chapter eleven, which includes flour. Similarly, under NAFTA’s RoOs, tomato ketchup qualifies as originating if it is made of imported inputs of any other chapter of the Harmonized System except subheading HS 200290 (tomato paste). This means that, in order to qualify, ketchup may contain imported fresh tomatoes but not imported tomato paste. This requirement is said to have been included in order to protect Mexican tomato-paste producers from Chilean competition (on this, see Brenton and Imagawa 2004 or Palmetser 1997).
have the highest restrictiveness values. Secondly, both NAFTA and the
EU’s PANEURO are characterized by PSROs that tend to be complex,
heterogeneous, and more stringent for goods with roundabout produc-
tion processes (where they do most harm).\textsuperscript{14} This trend may become
important also in most recent FTAs in Asia, where intraregional and
intraindustry trade is particularly important. Meanwhile, PTAs formed
among less-developed countries tend to have more uniform Rules of
Origin across products and lower restrictiveness values overall.

Thirdly, they highlight, on the basis of data aggregated over all PTAs,
a disturbing trend toward increasing stringency of PSROs. While the PTAs
formed in the 1980s and early 1990s tended to employ relatively simple
and non-restrictive PSROs and only few regime-wide rules, ‘new-generation’
PTAs have adopted stringent and selective regimes, although somewhat
counterbalancing these features with facilitation provisions. However,
recent agreements display high creativity in \emph{ad hoc} mechanisms and
instruments for the design and implementation of RoOs. For instance,
the application of stringent PSROs can be temporarily suspended
under ‘short-supply’ clauses allowing for lower regional value in cases of
shortage of suitable intermediate products in the preferential area. Such
clauses may bring welcome flexibility, but they may also encourage the
use of otherwise stringent PSROs by creating a perception that not much
damage can be done.

Estevadeordal and Suominen also develop a ‘facilitation index’ summar-
ing information on regime-wide rules. Many such rules, such as those
permitting cumulation,\textsuperscript{15} can somehow counteract the restrictiveness of

\textsuperscript{14} However RoOs can also be extraordinarily complex for goods whose origin would appear
at first sight straightforward to establish. The EU’s RoO for fish under the Cotonou Agreement,
for instance (which matters a lot for the Seychelles), requires not just that the fish be caught
in the territorial waters of an eligible (ACP) country. In addition, the fish landing at an EU port
should carry documentation establishing that the following criteria are met:

1. The vessel’s captain, officers and at least 50\% of its crew were nationals of an EU or
ACP state;
2. It was registered in an EU or ACP state;
3. It sailed under the flag of an EU or ACP state;
4. It was at least 50\% owned by nationals of an EU or ACP state (although under certain
conditions leased or chartered vessels can qualify);
5. The chairman and the majority of the board members of the company owning the vessel
were nationals of an EU or ACP state (Brenton and Imagawa 2004).

\textsuperscript{15} ‘Cumulation’ can take three forms. Bilateral cumulation allows say a Mexican producer
to use US inputs in the making of a product for re-export to the US. Diagonal cumulation
would allow the use of Canadian inputs (third party within the preferential zone) under the
same conditions. Full cumulation would allow non-originating inputs from the area (inputs
themselves made from imported components \emph{and} violating PSROs) to be treated as if they
were originating provided that the last stage of transformation satisfies the PSROs.
product-specific RoO. For instance, the larger the area where a PTA member can cumulate value to its final goods subsequently exported to its PTA partners, the larger the pool of inputs and processes available for the country’s producers, and the easier it becomes to comply with the product-specific RoO. This means that while restrictive product-specific RoO can be hypothesized to dampen trade, certain regime-wide RoO can compensate for it. Whereas higher values of the PSRO index mean more stringent rules, higher values of the facilitation index mean less restrictive cumulation rules.

Figure 4 shows a scatterplot of the two indices for the main PTAs currently in force. A loose correlation is apparent, suggesting that PTAs with generous cumulation rules tend, at the same time, to have stringent PSROs. This may suggest some political economy pressure by the export interests for loosening the RoO regime.

The figure, in which ‘better’ PTAs (characterized by light PSROs and generous regime-wide rules) lie to the Northwest, also illustrates the observation made earlier that neither NAFTA nor the EU’s PANEURO look very good in terms of the mixture of PSRO and regime-wide rules they offer, by comparison with other PTAs.

Figure 4 shows the average level but not the dispersion of PSRO restrictiveness across sectors. It turns out that the most restrictive PTAs in terms of average level are also those with the greatest sectoral selectivity in PSROs. That the ‘peak RoO stringency levels’ tend to fall on the agricultural, food, and textile & apparel sectors suggests that RoO may not be
a neutral instrument of preferential trade, but, rather, be driven by some of the same political-economy dynamics as other trade-protectionist instruments.

The issue raised by the proliferation of PTAs is not just the accompanying spread of restrictive RoO regimes around the world, but also their potential divergence. The more different regimes are from each other, the harder it will be to interlink existing PTAs with each other in the future—which, in turn, raises the risk of trade-diverting PTA blocs developing at the expense of global free trade. Abolishing RoO altogether (for example by bringing MFN tariffs to zero globally) would be the simplest means to counteract the potential negative effects of RoO. However, the politically more palatable option would be to harmonize preferential RoO at the global level. A good start might be limiting the types of RoO that can be employed in PTAs—in essence, setting RoO within a global band—and incorporating further facilitation mechanisms to the application of RoO regimes, for example, through generous cumulation provisions.

Interestingly, Americo Zampetti and Pierre Sauvè find that the RoOs applying to the producers of tradeable services tend to be less heterogeneous and opaque than those applying to goods, suggesting that rules for services have not (yet) become a battleground for special interests. However, they note that the rising importance of business-process outsourcing and other forms of service trade can quickly change the picture.

3. Rules of Origin and special interests

The value of RoOs as a protectionist device means that they can be endogenously determined by special interests. In their analysis of the political feasibility of FTAs, Grossman and Helpman (1995) focused on the exclusion of sensitive sectors and the length of phase-out periods. As noted by Duttagupta and Panagaryia (2003), RoOs are alternative instruments to win over special-interest support in favor of regional agreements.

Olivier Cadot, Antoni Estevadeordal and Akiko Suwa take some of the points raised by Anne Krueger and Kala Krishna to the test of structural estimation. If RoOs provide captive markets for upstream intermediates, they reason, lobbying by producers of those intermediates should have something to do with the observed pattern of product-specific RoOs. Using the classic common-agency approach to model influence activities, they derive the relation between endogenous tariffs and RoO stringency.
implied by influence activities upstream. Then, combining Esteva-deordal’s index with input-output data, they test for this relationship and find that the stringency of NAFTA’s RoOs indeed reflects a systematic pattern of influence by US producers of upstream intermediates. The benefit of tariff preferences for Mexican exporters being taken back by cost-raising RoOs, the system’s beneficiaries and losers are respectively US intermediate-good makers and taxpayers. In other words, the combination of tariff preferences and RoOs replicates the effect of an export subsidy for intermediates, going around the prohibition of such subsidies under GATT rules.

The econometric evidence is, in this regard, consistent with the historical evidence on NAFTA’s negotiations discussed by I. Mac Destler, who notes that NAFTA’s RoOs in the automobile sector were the result of a fine balancing act between the interests of Detroit’s car-makers who differed in their level of outsourcing. In textile, a ‘triple transformation test’ was elaborated. It required that to be treated as a North American product, a piece of apparel must have undergone three basic processes (fiber, cloth, clothing). This tight rule of origin seduced US mills in North and South Carolina by opening for them a captive market in Mexico, and thus, they gave up their traditional alliance with the domestic apparel industry.

As Destler notes, the rise of RoOs as an indirect tool of trade protection reflects both the increasing constraints weighing on the use of more traditional instruments and the slow erosion of the bipartisan consensus on free trade that dominated US postwar politics. To take the words of A. Spilimbergo, Rules of Origin are part of a Faustian pact, made to win the approval of a FTA from an originally reluctant constituency.

4. Measuring the impact of RoOs

Céline Carrère and Jaime de Melo take the econometric treatment of RoOs one step closer to what is arguably the key empirical question: how much do they cost? Their approach consists of extracting information on the cost of complying with RoOs by looking at preference utilization rates. Using simple assumptions on the relationship between utilization rates and compliance costs, they derive an ad valorem equivalent of 3.2% for NAFTA’s RoOs. This may not seem terribly high but the figure is substantially higher for textile & apparel products, where tariff lines with 100% NAFTA utilization rates, which enjoy average tariff preferences of
9.7%, bear estimated RoO compliance costs of 5.6%. Interestingly from a policy perspective, Carrère and de Melo’s estimates suggest that technical requirements are the costliest forms of RoOs, no doubt because their opacity makes them easily to manipulate.

Pablo Sanguinetti and Eduardo Bianchi’s analysis of Mercosur’s RoOs is one of the few analyses available of South-South PTAs (together with the analysis of SADC by Flatters and Kirk later in this volume). The Free Trade Agreements (FTAs) signed by Chile and Bolivia with Mercosur (itself a Customs Union) provide a quasi-laboratory to analyse how FTA-CU differences affect the design of RoOs. Sanguinetti and Bianchi also use the fact that external-tariff harmonization is imperfect in Mercosur to assess how external-tariff differences affect RoO stringency on the basis of an index à la Estevadeordal. As it turns out, large differences between external tariffs are associated with stiff RoOs, especially when the high-tariff country is Brazil, suggesting that the latter’s political weight was prominent in the design of Mercosur’s RoOs.

Joseph Francois departs from the usual analytical setting (in which inputs from different sources are perfect substitutes) by introducing a model à la Ethier in which input diversity raises productive efficiency. In this framework, RoOs reduce intra-FTA trade in final goods (because the cost of producing goods for export in the FTA is raised by RoOs) whereas the opposite is true for trade in intermediate products (because RoOs create a captive market for them). These effects are not at play in Custom Unions where RoOs are unnecessary. Francois takes these hypotheses to the data using automobile trade across a variety of PTAs, including NAFTA and the Turkey-EU Customs Union. He finds evidence that trade patterns are affected by RoOs in just the way predicted by the theory; in particular that NAFTA results in substantial trade diversion in intermediates.

Frank Flatters and Robert Kirk offer a detailed account of how the RoOs of the South African Development Community (SADC), initially simple and homogenous, have been progressively transformed by special-interest influence into a complex and ad hoc system. Their account of the negotiations interestingly highlights one of the running themes of this

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16 Carrère and de Melo’s econometric estimates are in line with earlier, non-parametric estimates by Anson et al. (2005) that placed administrative costs at 1.8% and costs related to increased input prices at 4.4%.

17 One of the primary justifications of RoOs is to prevent the trans-shipment of imported goods across a free-trade area’s internal borders. Otherwise, member states with low external tariffs would act as ports of entry for the whole area and would deprive others of tariff revenue. However, in a CU, agreement on a Common External Tariff eliminates this problem and hence the need for RoOs. Their presence in Mercosur is thus in and by itself suggestive of other, presumably political-economy driven, motivations.
volume, namely the linkage between lobbying for RoOs and lobbying for other forms of protection (such as long tariff phase-outs). They also take argument with widespread developmental justifications for RoOs, showing for instance how SADC member countries with established processed-food manufacturers sometimes push for stiff RoOs knowing full well that other member countries have no production at all of the relevant upstream intermediates. The result is then to establish monopoly positions for the processed-food manufacturers and preclude intra-SADC trade.\footnote{They cite the edifying example of ongoing negotiations on wheat flour, where South Africa is asking for a stiff local-content requirement, although this would essentially preclude flour trade among SADC members because wheat production is marginal in the area. The reason officially invoked on the South African side is to offset the high cost of local wheat, itself due to wheat protection. But, because millers have market power, they buy wheat from farmers at close to its world price. Thus, the wheat tariff as a matter of fact does \textit{not} protect farmers and only serves as convenient justification for a stiff RoO that would reinforce the millers’ market power.}

Finally, Paul Brenton and Takako Ikezuki examine the non-reciprocal preferences granted by the US, EU and Japan to the Least Developed Countries (LDCs). Assessing the ‘value of preferences’ on the basis of coverage,\footnote{A preference scheme with given coverage can have very different implications for different exporting countries depending on their prior trading structures, as eligible tariff lines can be high-volume ones for a country and low-volume ones for another. Of course, once preferences are in place trading structures tend to adjust endogenously to take advantage of them.} preference margins and utilization rates, they find that it varies considerably across exporter countries and sectors. US preferences on Textile & Apparel appear most valuable to Lesotho, Kenya and Swaziland, whereas EU preferences appear most valuable to Swaziland, Malawi, Mauritius and the Seychelles, primarily on account of the sugar protocol (except for the Seychelles for which it is fish that matters). For most of the rest of sub-Saharan Africa, the value of preferences is only marginal, the reason being essentially the cost of complying with RoOs. Using an approach close to that of Anson \textit{et al.} (2005)—namely using the average tariff-preference margin for lines with utilization rates strictly between zero and 100\% as a proxy for RoO costs—they put the price tag of complying with RoOs at 6.7\% in \textit{ad valorem} equivalent for US-bound exports, 8.4\% for EU-bound, and 5.6\% for Japan-bound.

5. Concluding remarks

Where does this all leave us? As Destler notes, constraints weighing increasingly heavily on the use of traditional instruments of trade protection have led to a search for GATT-compatible substitutes. Those
include all forms of contingent protection (anti-dumping, safeguard and countervailing duties) but also made-to-measure Rules of Origin.

In a way, RoOs were the perfect protectionist instrument. Because their determination is a very technical exercise, it naturally calls for input from companies with interest in the outcome. The result is, unsurprisingly, often hard-wired. This has largely gone unnoticed because, for quite a while, RoOs have been allowed to grow and gain force behind the veil of technicality and expert-confined negotiations.

This book is an attempt to bring the issue closer to public scrutiny. RoOs, all contributors argue, can do substantial damage to economic efficiency; they can also make market-access promises largely empty. The evidence suggests that, pretty much as uniform tariffs were promoted in the 1980s by Washington-based institutions to put an end to the fine tuning of tariffs to suit special interests, clear, uniform and moderate RoOs should be the goal of future negotiations. The South, in particular, stands to be hurt by rules that can be easily manipulated to render vacuous market-access promises made by the North in the course of bilateral negotiations. At least for as long as regionalism stays in fashion, putting demands for clear and transparent RoOs at the center of ongoing and future market-access negotiations should be a priority for Southern countries. Conversely, negotiators in South-South agreements should resist the temptation of opening the Pandora’s box of tailor-made RoOs.

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3

Mapping and measuring Rules of Origin around the world

A. Estevadeordal and K. Suominen

3.1 Introduction

 Preferential trading agreements (PTAs) have proliferated spectacularly around the world over the past decade.¹ The wave of PTA formation has carried with it a colorful mosaic of trade disciplines—such as provisions on market access for goods and services, standards, safeguards, government procurement, and investment—to govern economic relations between the PTA partners. These various rules dispersed through PTAs are hardly inconsequential given that more than a third of global commerce takes place within PTAs.² Moreover, reverberating to firms’ export, outsourcing, and investment decisions around the world, PTA disciplines arbitrate both actual and potential trade and investment flows within PTAs—and between PTAs and the rest of the world (ROW).

Yet, the richness of the PTA universe notwithstanding, there are astonishingly few rigorous efforts to disaggregate PTA agreements in order to analyse the operation and effects of the various rules they carry.³ This,

¹ PTAs include free trade agreements, customs unions, common markets, and single markets. Some 250 PTAs had been notified to the World Trade Organization (WTO) by the end of 2002; of these, 130 were notified after January 1995. The WTO expects the number of PTAs to soar to nearly 300 by the end of 2005.
² When unilateral preferential schemes such as the Generalized System of Preferences (GSP) are accounted for, no less than 60 per cent of world trade is estimated to be conducted on a preferential basis. Importantly, the unilateral preferential programs carry many of the same disciplines as PTAs.
³ The few mappings of PTA disciplines include WTO (1998, 2002a,b), IADB (2002), and Suominen (2004) produced in tandem with this chapter. The few existing rigorous, scholarly studies on the determinants of PTA provisions (beyond the contributions on Rules of Origin
in turn, implies that (1) very little is known about the compatibility of PTA agreements with one another or with the multilateral WTO Agreements; (2) the political economy sources of the divergent contractual formats of PTAs remain unexplored; and (3) analysts have yet to disentangle the respective economic effects of the different PTA disciplines from each other, let alone from the effects of variables beyond PTAs. The lack of understanding of the various component parts of the rapidly burgeoning PTA universe severely undercuts the credibility and usefulness of the arguments of both those who view PTAs as discriminatory instruments, hostage to protectionist interests that work to obstruct global trade liberalization, and those who regard PTAs as containing a liberalizing logic conducive to multilateral opening.

The purpose of this chapter is to break new ground in dissecting PTAs by focusing on Rules of Origin (RoO), a crucial yet poorly understood market access discipline included in virtually every PTA. The economic justification for RoO is to curb trade deflection—to avoid products from non-PTA members from being trans-shipped through a low-tariff PTA partner to a high-tariff one. As such, RoO are an inherent feature of free trade agreements (FTAs) where the member states’ external tariffs diverge and/or where the members wish to retain their individual tariff policies vis-à-vis the ROW. RoO are also widely used in customs unions (CUs), either as a transitory tool in the process of moving toward a common external tariff (CET), or as a more permanent means of covering product categories where reaching agreement on a CET is difficult, for instance due to large tariff differentials between the member countries. Thus, basically all PTAs contain rules for establishing the origin of goods.\(^4\) RoO are not only a central facet of preferential trading today, but also at the heart of many ongoing PTA negotiations, such as the 34-country talks to establish the Free Trade Area of the Americas (FTAA), and the European Union-Southern Common Market (Mercosur) negotiations to connect the world’s two largest customs unions. In addition, RoO are gaining growing policy attention at the multilateral level: in preparation for the Doha Trade Round, the WTO’s Committee on Regional Trade Agreements has for the

in this volume) tend to center on a single PTA and examine intersectoral variation in its market access provisions. See Milner (1997); Kowalczyk and Davis (1998); Olarreaga and Soloaga (1998); and Estevadeordal (2000). For the effects of PTAs’ market access provisions, see Estevadeordal and Robertson (2002) and Ghosh and Yamarik (2003).

\(^4\) The Asia-Pacific Cooperation (APEC) forum is a prominent exception, with its members employing their respective domestic RoO. APEC is based on a principle of open regionalism—extending tariff preferences on an MFN basis—which renders the need for preferential RoO obsolete.
first time raised preferential RoO to a systemic issue in the negotiation agenda.

Since a failure to meet the RoO disqualifies an exporter from the PTA-conferred preferential treatment, RoO can and must be seen as a central market-access instrument reigning over preferential trade. Notably, the relevance of RoO as gatekeepers of commerce can accentuate over time: RoO remain in place even after preferential tariffs have been phased out. But what renders RoO particularly relevant is that they are hardly a neutral instrument: given that RoO can serve as an effective means to deter transshipment, they can tempt political-economy uses well beyond the efforts to avert trade deflection. Indeed, RoO are widely considered a trade-policy instrument that can work to offset the benefits of tariff liberalization. Often negotiated at up to 8- or 10-digit levels of disaggregation, RoO, like the tariff, make a superbly targetable instrument. Moreover, that RoO are generally defined in highly technical terms rather than assigned a numerical value entails that they can be tailored for each individual product differently, and that they are not nearly as immediately quantifiable and comparable across products as the tariff is.

It is the use of RoO as a political economy instrument that helps account for the choice of RoO to govern preferential economic exchange—for the integrating governments’ willingness to expend time and resources on the tedious, technical, and often highly contentious crafting of RoO protocols. After all, governments could completely forego using RoO by entering into a CU or by excluding the potentially trade-deflecting economic sectors from the PTA’s coverage. Yet, the bulk of PTAs employ RoO, and RoO of widely different types and combinations.

Notwithstanding RoO’s function of refereeing preferential market access, potential uses for distributive purposes, complexity in existing PTAs and centrality in ongoing PTA negotiations, and increasing relevance on the multilateral agenda, the global RoO panorama remains largely unexplored. It is the task of this chapter to mend this gap. We present a

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5 Most prominently, RoO can be employed to favor intra-PTA industry linkages over those between the PTA and the ROW, and, as such, to indirectly protect PTA-based input producers vis-à-vis their extra-PTA rivals (Krueger 1993; Krishna and Krueger 1995). As such, RoO are akin to a tariff on the intermediate product levied by the importing country (Falvey and Reed 2000; Lloyd 2001), and can be used by one PTA member to secure its PTA partners’ input markets for the exports of its own intermediate products (Krueger 1993; Krishna and Krueger 1995). Furthermore, given that RoO hold the potential for increasing local sourcing, governments can use RoO to encourage investment in sectors that provide high value added and/or jobs (Jensen-Moran 1996; Hirsch 2002).

6 The exceptions are WTO (2002a), Estevadeordal and Suominen (2003), and Suominen (2004) produced in tandem with this chapter.
global mapping of the existing RoO regimes, and put forth an analytical coding scheme for the types of product-specific and regime-wide RoO employed in these regimes. The most immediate contribution of this chapter is to advance the understanding of the RoO regimes around the world. Except for Suominen (2004) produced in tandem with this chapter, there are no comparable mappings; the contribution here is the first of its kind. The analytical tools developed here are already employed in empirical work, both in our efforts to capture the global trade effects of RoO, and in Estevadeordal, López-Córdova and Suominen (2005). The Impact of NAFTA’s Market Access Provisions on the Location of Foreign Direct Investment in Mexico. Mimeograph.) of this book that focuses on RoO’s effects on investment. This chapter also strives to inspire further work aimed at disaggregating preferential trading arrangements into their component parts—a task that is absolutely crucial for understanding the implications of regionalism for the global economic system, as well as for crafting nuanced, well-informed, and fruitful policy prescriptions concerning PTAs.

The first section of this chapter presents the different types of product-specific and general RoO used in RoO regimes. The second section examines the prevalence of the different types of RoO in a hundred integration schemes in the world. Section three puts forth a methodology for developing analytical measurements of the degree of restrictiveness of product-specific RoO and flexibility provided by regime-wide RoO, and uses these measures to draw comparisons within and across RoO regimes as well as over time. The fourth section discusses the RoO innovations. Section five concludes.

### 3.2 Types of Rules of Origin in FTAs

There are two types of Rules of Origin, non-preferential and preferential RoO. Non-preferential RoO are used to distinguish foreign from domestic products in establishing anti-dumping and countervailing duties, safeguard

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7 WTO (2002a) does provide a charting of various features of RoO regimes. However, this chapter goes well beyond the WTO’s study by including a greater number of regimes, analysing in much greater detail the universe of product-specific RoO, examining a broader range of regime-wide RoO, discussing RoO innovations, and, perhaps most importantly, developing methodologies for capturing the relative restrictiveness of RoO and RoO regimes.

8 See Estevadeordal and Suominen (2004a) and Suominen (2004) for trade effects; see Estevadeordal (2000) and Suominen (2004, 2003) for the political economy of restrictiveness of RoO.
measures, origin-marking requirements, and/or discriminatory quantitative restrictions or tariff quotas, as well as in the context of government procurement. Preferential RoO, meanwhile, define the conditions under which the importing country will regard a product as originating in an exporting country that receives preferential treatment from the importing country. PTAs, in effect, employ RoO to determine whether a good qualifies for preferential treatment when exported from one member state to another.

Both non-preferential and preferential RoO regimes have two dimensions: sectoral, product-specific RoO, and general, regime-wide RoO. We discuss each in turn.

**A. Product-specific RoO**

The Kyoto Convention recognizes two basic criteria to determine origin: wholly obtained or produced, and substantial transformation. The wholly obtained or produced-category applies only to one PTA member, and asks whether the commodities and related products have been entirely grown, harvested, or extracted from the soil in the territory of that member, or manufactured there from any of these products. The rule of origin is met through not using any second-country components or materials. Most countries apply this strict and precise definition.

The substantial-transformation criterion is more complex, involving four main components that can be used as standalone or in combinations with each other. The precision with which these components define RoO in PTAs today contrasts sharply with the vagueness of the substantial transformation-criterion as used by the United States since 1908 until the inception of the Canada-US Free Trade Agreement (CUSFTA) in 1989 and, subsequently, the North American Free Trade Agreement (NAFTA) in 1994 (Reyna 1995: 7).

The first component of the substantial transformation criterion is a change in tariff classification (CTC) between the manufactured good and the inputs from extra-PTA parties used in the productive process. The CTC may require the product to alter its chapter (2 digits under the Harmonized

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9 The Revised Kyoto Convention is an international instrument adopted by the World Customs Organization (WCO) to standardize and harmonize customs policies and procedures around the world. The WCO adopted the original Convention in 1974. The revised version was adopted in June 1999.

10 The old criterion basically required the emergence of a 'new and different article' from the manufacturing process applied to the original article. It was, however, much criticized for allowing—and indeed requiring—subjective and case-by-case determinations of origin (Reyna 1995: 7).
Mapping and measuring Rules of Origin around the world

System), heading (4 digits), subheading (6 digits) or item (8–10 digits) in the exporting PTA member.

The second criterion is an exception attached to a particular CTC (ECTC). ECTC generally prohibits the use of non-originating materials from a certain subheading, heading, or chapter.

The third criterion is value content (VC), which requires the product to acquire a certain minimum local value in the exporting country. The value content can be expressed in three main ways: as the minimum percentage of value that must be added in the exporting country (domestic or regional value content, RVC); as the difference between the value of the final good and the costs of the imported inputs (import content, MC); or as the value of parts (VP), whereby originating status is granted to products meeting a minimum percentage of originating parts out of the total.

The fourth RoO component is technical requirement (TECH), which requires the product to undergo certain manufacturing operations in the originating country. TECH essentially prescribes or prohibits the use of certain input(s) and/or the realization of certain process(es) in the production of the good. It is a particularly prominent feature in RoO governing textile products.

The change-of-heading requirement is the staple of PTAs. It is used either as standalone or in tandem with other RoO criteria. Also frequently used are the import content (usually ranging from 30 to 60 per cent), value of parts, and technical requirements. Adding analytical complexity, albeit administrative flexibility, is that many RoO regimes provide two alternative RoO for a given product, such as a change of chapter or, alternatively, a change of heading plus RVC.

B. Regime-wide RoO

Besides product-specific RoO, RoO regimes vary by the types of general RoO they employ—including in the degree of de minimis, the roll-up principle, and the type of cumulation.

First, most PTAs contain a de minimis rule, which allows for a specified maximum percentage of non-originating materials to be used without affecting origin. The de minimis rule inserts leniency in the CTC and TECH criteria by making it easier for products with non-originating inputs to qualify.

11 TECH can be highly discrentional due to complicating and evaluation of sufficient transformation in the production of the good.
Secondly, the roll-up or absorption principle allows materials that have acquired origin by meeting specific processing requirements to be considered originating when used as input in a subsequent transformation. That is, when roll-up is allowed, non-originating materials are not taken into account in the calculation of the value added of the subsequent transformation.

Thirdly, cumulation allows producers of one PTA member to use materials from another PTA member (or other members) without losing the preferential status of the final product. There are three types of cumulation. Bilateral cumulation operates between the two PTA partners and permits them to use products that originate in the other PTA partner as if they were their own when seeking to qualify for the PTA-conferrered preferential treatment in that partner. Basically, all RoO regimes apply bilateral cumulation. Under diagonal cumulation, countries tied by the same set of preferential origin rules can use products that originate in any part of the common RoO zone as if they originated in the exporting country. Full cumulation extends diagonal cumulation. It provides that countries tied by the same RoO regime can use goods produced in any part of the common RoO zone even if these were not originating products: any and all processing done in the zone is calculated as if it had taken place in the final country of manufacture. As such, diagonal and full cumulation can notably expand the geographical and product coverage of a RoO regime. Table 3.2 illustrates the frequency of general RoO provisions around the world.

Whereas de minimis, roll-up, and cumulation allow for leniency in the application of RoO, there are three provisions that may have the opposite effect and increase the stringency of RoO.

First, most PTAs contain a separate list indicating the operations that are in all circumstances considered insufficient to confer origin, such as preservation during transport and storage, as well as simple operations of cleaning, sorting, painting, packaging, assembling, and marking and labelling.

Secondly, many PTAs prohibit duty drawback—preclude the refunding of tariffs on non-originating inputs that are subsequently included in a

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12 In bilateral cumulation, the use of the partner-country components is favored; in diagonal cumulation, all the beneficiary trading partners of the cumulation area are favored. Full cumulation is more liberal than diagonal cumulation by allowing a greater use of third-country materials. However, it is rarely allowed in RoO regimes.

13 To be sure, non-members to a cumulation area may view the cumulation system as introducing another layer of discrimination by virtue of its providing incentives to the member countries to outsource from within the cumulation zone at the expense of extra-zone suppliers.
final product that is exported to a PTA partner. Many developing countries employ drawback in order to attract investment and to encourage exports; however, drawback in the context of a PTA is viewed as providing a cost advantage to the PTA-based producers who gear their final goods to export over producers selling their final goods in the domestic market.\footnote{Cadot \textit{et al.} (2001) show that duty drawback may have a protectionist bias due to reducing the interest of producers to lobby against protection of intermediate products.} The end of duty drawback entails an increase in the cost of non-originating components for PTA-based final-goods producers. As such, the end of drawback in the presence of cumulation may encourage intra-PTA producers to shift to suppliers in the cumulation area (WTO 2002a).

Thirdly, a complex method of certifying the origin of goods can impose high administrative costs on exporters. The main certification methods are self-certification by exporters, certification by the exporting country government or an industry umbrella group to which the government has delegated the task of issuing the certificate, and a combination of the ‘private’ self-certification and the ‘public’ governmental certification. The more numerous the bureaucratic hurdles and the higher the costs for an exporter to obtain an origin certificate, the lower the incentives to seek PTA-conferred preferential treatment.

3.3 Rules of Origin around the world

This section turns to examining the great variety of combinations of product-specific and regime-wide RoO used in selected PTAs in Europe, the Americas, Asia-Pacific, Africa, and the Middle East, as well as in PTAs between these regions. We subsequently discuss the structure of non-preferential RoO. The latter part of this section presents an analytical, comparative assessment of (1) the relative restrictiveness of the product-specific RoO governing different economic sectors in the different RoO regimes; and (2) the degree of flexibility instilled in the various RoO regimes by the regime-wide RoO.

A. Comparing the structure of RoO regimes in five regions

\textit{i. Europe: expansion of the PANEURO system}

The RoO regimes employed across the EU’s FTAs are highly uniform \textit{vis-à-vis} each other. This is due largely to the European Commission’s recent
drive to harmonize the EU’s existing and future preferential RoO regimes in order to facilitate the operations of EU exporters dealing on multiple trade fronts, and to pave the way for particularly the EU’s East European FTA partners to draw greater benefits from the EU-provided preferential treatment via diagonal cumulation—that was previously precluded by the lack of compatibility among the EU’s RoO regimes. The harmonization efforts pertained to product-specific and regime-wide RoO alike. They extended to EU’s RoO protocols with the European Free Trade Association (EFTA) countries that dated from 1972 and 1973, as well as across the EU’s FTAs forged in the early 1990s in the context of the Europe Agreements with Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Romania. The work culminated in 1997 in the launch of the Pan-European (PANEURO) system, which established identical RoO protocols and product-specific RoO across the EU’s existing FTAs, thereby providing for diagonal cumulation among the participating countries. The Commission’s regulation 46 of January 1999 reiterates the harmonized protocols, outlining the so-called single-list RoO. Overall, the PANEURO RoO are highly complex, combining CTC mainly at the heading level with exceptions, VC, and TECH, and varying markedly across products.

Since 1997, the PANEURO model has become incorporated in the EU’s newer FTAs, including the Euro-Mediterranean Association Agreements, the Stabilization and Association Agreements with Croatia and the Former Yugoslav Republic of Macedonia, the EU-Slovenia FTA, as well as the extra-regional FTAs with South Africa, Mexico, and Chile. Also, the RoO of the EU’s generalized system of preferences (GSP) and the 2000 Cotonou Agreement with the African, Caribbean, and Pacific (ACP) developing countries approximate the single-list, PANEURO model. EFTA’s recently concluded FTAs with Mexico and Singapore follow the PANEURO model, albeit providing an additional alternative rule in selected sectors—such as plastics, rubber, textiles, iron and steel products, and some machinery products.

15 See Driessen and Graafsma (1999) for a review.
16 The harmonized RoO do not represent a dramatic break with those of the pre-1997 era. For example, the RoO in nearly 75 per cent of the products (in terms of tariff subheadings) in PANEURO and the original EU-Poland RoO protocol published in 1993 are identical. Both the new and the old versions combine CTC with VC and/or TECH. Indeed, EU RoO feature remarkable continuity: the RoO of the European Community-Cyprus FTA formed in 1973 are strikingly similar to the PANEURO model used today. One notable difference between the older and the newer protocols is that the latter allow for an optional way of meeting the RoO for about 25 per cent of the products, whereas the former specify mostly only one way of meeting the RoO. The second option, alternative RoO, much like the first option RoO, combines different RoO criteria; however, the most frequently used alternative RoO is a standalone import-content criterion.
Importantly, the EU’s eastward enlargement 1 May 2004 terminated the FTAs forged among the 10 new member states and also between them and the EU. The new members became incorporated in the EU customs union; as such, they set out to apply the EU’s CET, with their overall external tariffs dropping from nine to four per cent, and also assumed the rights and obligations of the FTAs that the EU has in place with non-member countries.

ii. The Americas: four RoO families

There is much more variation across RoO regimes in the Americas. Nevertheless, distinct RoO families can be identified (Garay and Cornejo 2002). One extreme is populated by the traditional trade agreements such as the Latin American Integration Agreement (LAIA), which uses a general rule applicable across the board for all tariff items (a change in tariff classification at the heading level or, alternatively, a regional value content of at least 50 per cent of the FOB export value of the final good). The LAIA model is the point of reference for RoO used in the Andean Community (CAN) and Caribbean Community (CARICOM). At the other extreme lie the so-called new-generation PTAs such as NAFTA, which is used as a reference point for the US–Chile, US–Central America and Dominican Republic (CAFTA), Mexico–Costa Rica, Mexico–Chile, Mexico–Bolivia, Mexico–Nicaragua, Mexico–Northern Triangle (El Salvador, Guatemala, and Honduras), Chile–Canada, and Mexico–Colombia–Venezuela (or G-3) FTAs. The RoO regimes in these agreements may require a change of chapter, heading, subheading or item, depending on the product in question. In addition, many products combine the change of tariff classification with an exception, regional value content, or technical requirement. The NAFTA model, particularly the versions employed in the US–Chile FTA and CAFTA, is also widely viewed as the likeliest blueprint for the RoO of the Free Trade Area of the Americas (FTAA).

Mercosur RoO, as well as RoO in the Mercosur–Bolivia and Mercosur–Chile FTAs fall between the LAIA–NAFTA extremes. They are mainly based on change of heading and different combinations of regional value content and technical requirements. The Central American Common Market’s (CACM) RoO regime can be seen as being located between those of the Mercosur and NAFTA: it uses chiefly change in tariff classification only, but in more precise and diverse ways than Mercosur due to requiring the change to take place at either the chapter, heading, or subheading level, depending on the product in question. The recently concluded CAFTA will, once ratified by all parties, coexist with the CACM’s market access mechanisms under the so-called multilateralism principle, which allows
Central American producers to choose between the CACM and CAFTA market access regimes when exporting to the other Isthmus markets.

Notably, unlike the EU’s extra-European FTAs that follow the PANEURO system, US bilateral FTAs with extra-Hemispheric partners—Jordan and Israel—differ markedly from the NAFTA model, operating on VC alone. However, the RoO of the US–Singapore FTA are again more complex, resembling the NAFTA RoO. Similarly, the RoO of the recently forged Chile–South Korea FTA also feature a high degree of sectoral selectivity à la NAFTA, and, indeed, the US–Chile FTA. Nonetheless, the RoO of the Chile–Korea regime are overall less complex than either NAFTA or US–Chile RoO, and also more reliant on the change in heading criterion than NAFTA, which has an important change in chapter component, and US–Chile FTA, which features an important change in subheading component.

iii. Africa, Asia, Middle East: toward sectoral selectivity?

The relative complexity of RoO in Europe and the Americas stands in contrast to the generality of RoO in many Asian, African, and Middle Eastern PTAs. Some of the main integration schemes in these regions—the ASEAN Free Trade Area (AFTA), Australia–New Zealand Closer Economic Relations Trade Agreement (ANZCERTA), Singapore–Australia Free Trade Agreement (SAFTA), and South Pacific Regional Trade and Economic Cooperation (SPARTECA) in Asia–Pacific; the Economic Community of West African States (ECOWAS), Common Market for Eastern and Southern Africa (COMESA), and Namibia–Zimbabwe FTA in Africa; and the Gulf Cooperation Council (GCC) in the Middle East—are based on an across-the-board VC rule that, when defined as RVC, ranges from 25 per cent (in Namibia–Zimbabwe FTA) to 50 per cent (ANZCERTA). Some of the agreements allow, or, indeed, require, RoO to be calculated on the basis of import content. Most of these regimes also specify an alternative RoO based on the CTC criterion; most often the alternative involves a change in heading or, in the case of ECOWAS that has a relatively low RVC requirement of 30 per cent, change in subheading.

However, the more recent RoO regimes in both Africa and Asia-Pacific carry RoO of high degrees of sectoral selectivity. The Southern African Development Community (SADC) RoO approximate the PANEURO model both in the types of sectoral RoO and in sectoral selectivity. Moreover, there have been some initiatives to renegotiate COMESA RoO; such attempts may well eventually lead to regimes of greater complexity. On the Asian front, the RoO of the Japan-Singapore Economic Partnership Agreement (JSEPA) are also complex, as evinced by the more than
200-page RoO protocol. However, much like in the Chile-Korea FTA, nearly half of JSEPA RoO are based on a simple change in heading criterion, which makes the regime much less complex than the PANEURO and NAFTA models. Furthermore, for many products JSEPA introduces an alternative, usually PANEURO-type, free-standing VC rule, which instills generality and flexibility to the agreement.

The intercontinental RoO regimes of the US-Singapore and Chile-Korea FTAs have delivered additional complexity to the Asia-Pacific RoO theater. RoO in these agreements tend to follow the NAFTA model yet be notably less complex overall, featuring a strong change of heading component. The future Mexico-Singapore, Canada-Singapore, Mexico-Korea, Mexico-Japan, and US-Australia FTAs, among others, will likely compound this trend. Meanwhile, further European overtures to the Asian front will likely bring the PANEURO model to accompany the NAFTA model in the region.

B. Non-preferential RoO

Non-preferential RoO are used for purposes distinct from those of preferential rules. Even if a country did not use preferential RoO, it would still apply some type of non-preferential RoO. Unlike preferential RoO that have thus far escaped multilateral regulation, non-preferential RoO have been under a process of harmonization since 1995 as mandated by the Uruguay Round’s Agreement on Rules of Origin (ARO). The harmonization work, propelled precisely by growing concerns about the divergent national RoO’s effects on trade flows, has been carried out under the auspices of the Committee on Rules of Origin (CRO) of the World Trade Organization (WTO) and the Technical Committee on Rules of Origin (TCRO) of the Brussels-based World Customs Organization. The latter has been responsible for the technical part of the work, including discussions on the RoO options for each product.

The harmonization drive was initially scheduled for completion by July 1998. However, the deadline has been extended several times since then. The Technical Committee’s work was concluded in 1999, with about 500 pending issues that could not be solved at the technical level being sent to the CRO in Geneva. As of July 2003, the process at the WTO had yet to reach a solution to 94 core policy issues; these affect an estimated fifth of the tariff subheadings of the entire tariff universe. The General Council at the time extended the deadline for completion of the issues to July 2004, and agreed that following resolution of these core policy issues, the CRO would complete its remaining work by the end of 2004. In their current
structure, the non-preferential RoO approximate the PANEURO and NAFTA models in sectoral specificity, yet are less demanding than either of the two main RoO regimes. However, since several issues are still contested at the WTO, the final degree of complexity and restrictiveness of the non-preferential RoO remains to be gauged.

C. Depicting product-specific RoO around the world

Figure 3.1 focuses on the first RoO component, the CTC criterion, in the RoO regimes of 29 PTAs around the world. These are three of the EU’s PTAs (PANEURO—where the RoO are basically fully identical to those of the EU–South Africa FTA—and the EU–Mexico and EU–Chile FTAs); EFTA-Mexico FTA where RoO approximate the EU–Mexico RoO model; seven FTAs drawing on the NAFTA RoO model that is gaining prominence in the Western Hemisphere (NAFTA, US–Chile, CAFTA, Group of Three, and Mexico–Costa Rica, Mexico–Bolivia, and Canada–Chile FTAs); CACM-Chile FTA; Mercosur–Chile and Mercosur–Bolivia FTAs; LAIA; seven PTAs in Asia–Pacific (ANZCERTA, SAFTA, SPARTECA, AFTA, Bangkok Agreement, JSEPA, and Chile–Korea FTA); four PTAs in Africa (ECOWAS, COMESA, Namibia–Zimbabwe FTA, and SADC); the Gulf Cooperation Council in the Middle East; and US extrahemispheric FTAs with Jordan and Israel. The two final sets of bars depict two potential outcomes of the harmonization process of the non-preferential RoO (as set to their ‘lowest’ and ‘highest’ levels of stringency, which will be discussed in the next section).17

The change-of-heading criterion dominates EU RoO, whereas the RoO built upon the NAFTA RoO regime are based on change of heading and change of chapter criteria at relatively even quantities. The US–Chile FTA and CAFTA stand somewhat apart from the NAFTA format for requiring only change in subheading for a substantial number of tariff lines. Meanwhile, the Chile-CACM FTA diverges from the NAFTA model due to its marked change in heading-component, as do the Japan–Singapore and Chile–Korea FTAs. The other Asian PTAs considered here stand out for their generality—for using an across-the-board value-content requirement exclusively. Except for the SADC, African RoO regimes are also marked by general, across-the-board CTC RoO, as are LAIA and Mercosur’s FTAs with Chile and Bolivia that employ the change-of-heading criteria across the RoO universe. In contrast to the PANEURO and NAFTA models, non-preferential RoO feature also a prominent change-of-subheading component.

17 The figure is based on the first RoO only when two or more possible RoO are provided for a tariff subheading.
Fig. 3.1 Distribution of CTC criteria by agreement.
Source: Authors' calculations on the basis of PTA texts.
Another notable difference between the various PTAs is that some, such as ANZCERTA, employ the VC criterion across sectors, completely foregoing the use of the CTC-criterion. The EU does this in about a quarter of its RoO; the bulk (more than 80 per cent) of these RoO are based on the wholly obtained criterion used particularly in agricultural products, or on the import-content rule that imposes a ceiling of 40–50 per cent to non-originating components of the ex-works price of the final product. The standalone import content RoO are used particularly frequently for optics, transportation equipment, and machinery and electrical equipment. Another idiosyncrasy of the EU RoO, yet one that escapes the figure here, is the use of the so-called ‘soft RoO’ in more than a quarter of the RoO requiring a change of heading and about a sixth of the RoO requiring a change of chapter. Soft RoO allows the use of inputs from the same heading (or chapter) up to a certain share of the price of the final product even when the RoO requires a change of heading (or change of chapter). The share is generally between 5 and 20 per cent.

Table 3.1 centers on the tariff subheadings governed by VC (including combinations of VC with CTC, and VC when employed as an alternative to a CTC criterion) in various RoO regimes, and, in particular, on the level of the VC criterion. The most usual level of VC is 40–50 per cent, whether defined as MC or RVC. However, in the US–Chile FTA, CAFTA, and Chile–CACM FTA, RVC is generally set at lower levels of 30–35 per cent; at the other extreme, for some products in the PANEURO and SADC regimes, the permitted value of non-originating inputs of the price of the final product is as low as 15–30 per cent. The table also displays the various bases for calculation of the VC. Differences in the method of calculation can have crucial implications to the exporters’ capacity to meet the RoO. The PE model that is separated here for analytical purposes essentially involves the same product-specific RoO as the PANEURO model, while diverging somewhat from the PANEURO in the regime-wide RoO. It applies to a handful of European FTAs, particularly to those forged by the EU and East European countries with Israel (WTO 2002a).

Capturing the full scale of variation in the RoO regimes requires a look at the various combinations of RoO components. Table 3.2 displays the RoO combinations in selected FTAs around the world. It considers the entire tariff universe in each RoO regime, and shows the percentage shares of all possible RoO types and combinations thereof in each respective regime. Particularly notable is the high degree of selectivity of PANEURO, NAFTA, and non-preferential RoO.
D. Regime-wide RoO

Besides sectoral RoO, the different RoO regimes can be compared by their regime-wide RoO. Table 3.3 contrasts the various RoO regimes by their general, regime-wide RoO—*de minimis*, roll-up, cumulation, and drawback.

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Table 3.1 VC criteria by agreement

<table>
<thead>
<tr>
<th>PTA</th>
<th>Value-content criterion (%)</th>
<th>Basis for calculation</th>
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<td>MC, RVC</td>
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<tr>
<td>MC RVC</td>
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Source: Authors’ classification based on PTA texts.
Mapping and measuring Rules of Origin around the world

First, EU’s RoO regimes feature a higher *de minimis* (at 10 per cent) than NAFTA and many other FTAs in the Americas; the exceptions are US–Chile FTA and CAFTA, where *de minimis* is the same as in PANEURO. Meanwhile, there is no *de minimis* rule in Mercosur’s FTAs and various FTAs in Asia and Africa. However, the principle does have exceptions in most regimes: for example, EU’s *de minimis* does not apply to textiles and apparel, except for allowing an 8 per cent *de minimis* of the total weight of textile materials in mixed textiles products. In the EU–South Africa FTA, *de minimis* is set at 15 per cent but excludes fish and crustaceans, tobacco products, as well as certain meat products and alcoholic beverages. NAFTA *de minimis* does not extend to the production of dairy produce; edible products of animal origin; citrus fruit and juice; instant coffee; cocoa products, and some machinery and mechanical appliances, such as air conditioners and refrigerators (Reyna 1995: 115–117).

Secondly, the roll-up principle is widely used around the world. For example, in NAFTA, a good may acquire originating status if it is produced in a NAFTA country from materials considered as originating (whether such materials are wholly obtained or have satisfied a CTC or RVC criterion) even if no change in tariff classification takes place between the intermediate material and the final product. Similarly, the EU–Mexico FTA stipulates that ‘if a product which has acquired originating status by fulfilling the conditions…is used in the manufacture of another product, the conditions applicable to the product in which it is incorporated do not apply to it, and no account shall be taken of the non-originating materials which may have been used in its manufacture.’

Thirdly, the EU’s Pan–European system of cumulation applied since 1997 draws a clear distinction between the EU RoO regimes on the one hand, and most RoO regimes elsewhere in the world, on the other. The foremost diagonal cumulation regime in the world, the Pan–European system incorporated 16 partners and covered no fewer than 50 FTAs prior to the EU’s eastward enlargement. In concrete terms, the system enables producers to use components originating in any of the participating countries without losing the preferential status of the final product. The European Economic Association (EEA) agreement between EU and EFTA permits full cumulation. The EU–South Africa FTA allows both parties to cumulate diagonally with the ACP states. In addition, it incorporates the

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85 The participants in the PANEURO system of cumulation prior to the eastward enlargement were the EU, Bulgaria, Czech Republic, Estonia, Hungary, Iceland, Latvia, Liechtenstein, Lithuania, Norway, Poland, Romania, Slovak Republic, Slovenia, Switzerland, and Turkey. Eight of these countries—Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, and Slovenia—entered the EU in May 2004.
### Table 3.2 Distribution of RoO combinations, selected PTAs (1st RoO only)

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### Notes:
- NC = No change in tariff classification required;
- CI = Change in tariff item;
- CS = Change in tariff subheading;
- CH = Change in tariff heading;
- CC = Change in tariff chapter;
- ECTC = Exception to change in tariff classification;
- VC = Value content;
- TECH = Technical requirement.

Calculations at 6-digit level of the Harmonized System.

**Source:** Author’s calculations on the basis of PTA texts.
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<th>Region</th>
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<td>FTBA</td>
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<td>No</td>
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<td>(full)</td>
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<td>Yes (full)</td>
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<td>No</td>
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<td>(full)</td>
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<td>Not mentioned</td>
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<tr>
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<td>Yes</td>
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<tr>
<td>Canada–Israel</td>
<td>10 (except in agric. and ind. products, 7% of weight in chs. 50–63)</td>
<td>Yes</td>
<td>Yes</td>
<td>(w/ a 3rd party with which both have FTA)⁶⁴</td>
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<tr>
<td>Mexico–Israel</td>
<td>10 (except in agric. and ind. products, 7% of weight in chs. 50–63)</td>
<td>Yes</td>
<td>Yes</td>
<td>Not mentioned</td>
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</tbody>
</table>

Source: Authors' classification on the basis of PTA texts.
‘single territory’ concept, whereby South Africa can calculate working or processing carried out within the Southern Africa Customs Union (SACU) area as if these had been performed in South Africa (but not in the EU).

Other cumulation schemes include the ANZCERTA model, which provides for full cumulation, and the Canada–Israel FTA, which permits cumulation with the two countries’ common FTA partners, such as the United States. Singapore’s FTAs incorporate the outward processing (OP) concept tailored to accommodate Singapore’s unique economic features and its access to low-cost processing in neighboring countries. The US–Singapore FTA also incorporates the integrated sourcing initiative (ISI), which provides further flexibility for outsourcing. OP and ISI will be detailed in Section 3.4. CAFTA stands out in the Americas for providing for diagonal cumulation with Canada and Mexico. However, the clause covers only materials used for producing goods in chapter 62, and so only up to a limited amount of imports to the US market and only after Canada and Mexico agree on the clause.

Fourthly, EU’s FTAs and FTAs in the Americas tend to explicitly preclude drawback. Nonetheless, both have allowed for phase-out periods during which drawback is permitted. For instance, the EU–Mexico FTA permitted drawback for the first two years, while the EU–Chile FTA allows drawback through 2007, the fourth year of the FTA. NAFTA allowed for drawback for the first seven years; however, drawback in the bilateral trade between Canada and the United States under the agreement was valid for only two years. Importantly, NAFTA does provide leniency in the application of the no-drawback rule by putting in place a refund system, whereby the producer will be refunded the lesser of the amount of duties paid on imported goods and the amount of duties paid on the exports of the good (or another product manufactured from that good) upon its introduction to another NAFTA member. AFTA, ANZCERTA, SPARTECA, the US–Israel FTA, CACM, and Mercosur’s FTAs stand out for not prohibiting drawback. However, in Mercosur per se, there is a no-drawback rule governing Argentine and Brazilian imports of intermediate automotive products when the final product is exported to a Mercosur partner; this should help place Paraguay and Uruguay at a par with the two larger economies in attracting investment in the automotive sector.

E. Administration of RoO

The various RoO regimes diverge in their administrative requirements, particularly in the method of certification (Table 3.4).
The EU RoO regimes require the use of a movement certificate, EUR.1, that is to be issued in two steps—by the exporting-country government once application has been made by the exporter or the exporter’s competent agency, such as a sectoral umbrella organization. However, the EU regimes provide for an alternative certification method, the invoice declaration, for ‘approved exporters’ who make frequent shipments and are authorized by the customs authorities of the exporting country to make invoice declarations.

Meanwhile, NAFTA and a number of other FTAs in the Americas as well as the Chile–Korea FTA rely on self-certification, which entails that the exporter’s signing the certificate suffices as an affirmation that the items

Table 3.4 Certification methods in selected PTAs

<table>
<thead>
<tr>
<th>PTA</th>
<th>Certification method</th>
</tr>
</thead>
<tbody>
<tr>
<td>PANEURO</td>
<td>Two-step private and public; limited self-certification</td>
</tr>
<tr>
<td>PE</td>
<td>Two-step private and public; limited self-certification</td>
</tr>
<tr>
<td>EU–South Africa</td>
<td>Two-step private and public; limited self-certification</td>
</tr>
<tr>
<td>EU–Mexico</td>
<td>Two-step private and public; limited self-certification</td>
</tr>
<tr>
<td>EU–Chile</td>
<td>Two-step private and public; limited self-certification</td>
</tr>
<tr>
<td>NAFTA</td>
<td>Self-certification</td>
</tr>
<tr>
<td>US–Chile</td>
<td>Self-certification</td>
</tr>
<tr>
<td>CAFTA</td>
<td>Self-certification</td>
</tr>
<tr>
<td>G3</td>
<td>Two-step private and public</td>
</tr>
<tr>
<td>Mexico–Costa Rica</td>
<td>Self-certification</td>
</tr>
<tr>
<td>Mexico–Bolivia</td>
<td>Self-certification (two-step private and public during first 4 years)</td>
</tr>
<tr>
<td>Canada–Chile</td>
<td>Self-certification</td>
</tr>
<tr>
<td>CACM–Chile</td>
<td>Self-certification</td>
</tr>
<tr>
<td>CACM</td>
<td>Self-certification</td>
</tr>
<tr>
<td>Mercosur</td>
<td>Public (or delegated to a private entity)</td>
</tr>
<tr>
<td>Mercosur–Chile</td>
<td>Public (or delegated to a private entity)</td>
</tr>
<tr>
<td>Mercosur–Bolivia</td>
<td>Public (or delegated to a private entity)</td>
</tr>
<tr>
<td>Andean Community</td>
<td>Public (or delegated to a private entity)</td>
</tr>
<tr>
<td>Caricom</td>
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<td>LAIA</td>
<td>Two-step private and public</td>
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<td>Bangkok Agreement</td>
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<td>Japan–Singapore</td>
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<td>Two-step private and public</td>
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<tr>
<td>US–Jordan</td>
<td>Self-certification</td>
</tr>
</tbody>
</table>

Source: Authors’ classification on the basis of PTA texts.
covered by it qualify as originating. In CAFTA, the importer rather than the exporter claiming preferential tariff treatment is the party ultimately responsible for seeing that the good is originating.\textsuperscript{19} In Mercosur, Andean Community, Caricom, AFTA, ANZCERTA, SAFTA, the Bangkok Agreement, JSEPA, and ECOWAS require certification by a public body or a private umbrella entity approved as a certifying agency by the government. However, unlike in the two-step model, the exporter is not required to take the first cut at filling out the movement certificate, but, rather, to furnish the certifying agency with a legal declaration of the origin of the product.\textsuperscript{20}

The self-certification model can be seen as placing a burden of proof on the importing-country producers; as such, it arguably minimizes the role of the government in the certifying process, entailing rather low administrative costs to exporters and governments alike. In contrast, the two-step system requires heavier involvement by the exporting-country government and increases the steps—and likely also the costs—that an exporter is to bear when seeking certification.

\textbf{3.4 Analytical coding methodology for RoO Rules of Origin in FTAs}

This section presents a methodology for measuring (1) the relative restrictiveness of the product-specific RoO governing different economic sectors in the different agreements; and (2) the degree of flexibility instilled in the various RoO regimes by the various regime-wide RoO, such

\textsuperscript{19} The CAFTA certification of origin can be prepared by the importer, exporter, or the producer of the good; alternatively, the importer can claim origin through his/her ‘knowledge that the good is an originating good’. Verification of origin can be made via written requests or questionnaires to the importer, exporter, or producer, or by visits by an importing-country authority to the exporting-party territory. Similarly, in the US-Chile FTA, the importer is to declare the good as originating and can also certify origin; however, verification can be made by the customs of the importing member ‘in accordance with its customs laws and regulations.’ In contrast, in NAFTA, the exporter or producer are parties in charge of certifying origin, and verification of origin is conducted through written requests or visits by one NAFTA member to the premises of an exporter or a producer in the territory of another member.

\textsuperscript{20} The certificate in NAFTA, G3, and CACM-Chile FTA will be valid for a single shipment or multiple shipments for a period of a year; in ANZCERTA and SAFTA, the certificate will be valid for multiple shipments for two years. In ECOWAS, the certificate is not required for agricultural, livestock products and handmade articles produced without the use of tools directly operated by the manufacturer. In ANZCERTA, SAFTA, and Mercosur–Chile, Mercosur–Bolivia, and CARICOM-DR FTAs, the certificate needs to be accompanied by a legal declaration by the final producer or exporter of compliance with the RoO. In CAN and CARICOM, declaration by the producer is required. In CARICOM, the declaration can be completed by the exporter if it is not possible for the producer to fill it.
as de minimis and drawback. We subsequently compare RoO regimes by the values yielded by these two analytical measures.

A. A comparative analysis of the levels of restrictiveness of product-specific RoO

The NAFTA RoO family is based on the change of chapter rules, whereas the change of tariff heading component figures prominently in the EU and most Asian and African RoO models. As such, these regimes will entail somewhat divergent demands on exporters. However, understanding the implications of membership in the different types of regimes for an exporter operating in a particular industry requires both (1) a measure of the restrictiveness of RoO that allows for a more nuanced sectoral analysis of the requirements imposed by RoO; and (2) an indicator of the overall flexibility instilled in a RoO regime by the various regime-wide RoO. This section presents two such measures: a restrictiveness index, and a facilitation index.

i. Restrictiveness of RoO

The manifold RoO combinations within and across RoO regimes present a challenge for cross-RoO comparisons. This chapter seeks to draw such comparisons through an index grounded on the plausible restrictiveness of a given type of RoO. Estevadeordal (2000) constructs a categorical index ranging from 1 (least restrictive) to 7 (most restrictive) on the basis of NAFTA RoO. The index can be conceptualized as an indicator of how demanding a given RoO is for an exporter. The observation rule for the index is based on two assumptions: (1) change at the level of chapter is more restrictive than change at the level of heading, and change at the level of heading more restrictive than change at the level of subheading, and so on; and (2) VC and TECH attached to a given CTC add to the RoO’s restrictiveness (see Appendix I for details).21

Figure 3.2 reports the restrictiveness of RoO as calculated at the six-digit level of disaggregation in selected FTAs. The EU RoO regimes are again strikingly alike across agreements. The RoO regimes based on the NAFTA model, such as the G-3, are also highly alike. The Mercosur model pertinent to Mercosur–Chile and Mercosur–Bolivia FTAs is more general, yet

21 Given that the degree of restrictiveness is a function of ex ante restrictiveness rather than the effective restrictiveness following the implementation of the RoO, the methodology—much like that of Garay and Cornejo (2002)—is particularly useful for endogenizing and comparing RoO regimes. The methodology allows RoO to be analysed in terms of their characteristics rather than their effects.
still exhibits more cross-sectoral variation in the restrictiveness of RoO than the LAIA model marked by the across-the-board change of heading RoO. The generality of the LAIA model is replicated by most Asian and African RoO regimes. However, some newer PTAs—such as Chile–Korea FTA and SADC—feature high levels of cross-sectoral variation in RoO.

iii. Comparing the restrictiveness of sectoral RoO

To what extent does the restrictiveness of RoO vary across economic sectors? Are some sectors more susceptible to the potential negative trade and investment effects of restrictive RoO than others?
We explore these questions by focusing on twelve RoO regimes with intersectoral variation in RoO. Table 3.5 reports the restrictiveness values in these regimes, as aggregated from 6-digit values by section of the Harmonized System. The average restrictiveness and the standard deviation values at the bottom of the table are based on calculations at the 6-digit level.

The data reveal that agricultural products and textiles and apparel are marked by a particularly high restrictiveness score in each regime, which suggests that the restrictiveness of RoO may be driven by the same political economy variables that arbitrate the level of tariffs particularly in the EU and the United States. Non-preferential RoO exhibit similar patterns across sectors, communicating the operation of political economy dynamics also at the multilateral level. Weighting the sectoral restrictiveness values with trade produces very similar results—which may in and of itself be an indication that stringent RoO stifle commerce.

B. Comparing regime-wide RoO: a facilitation index

Product-specific RoO in complex PTAs—PTAs not carrying across-the-board RoO—can impose highly divergent requirements to the exporters of different goods. Even an across-the-board rule will undoubtedly have more striking implications in some sectors than in others, depending on the product-specific features. However, as discussed above, RoO regimes employ several mechanisms to add flexibility to the application of the product-specific RoO. We strive to capture the combined effect of such mechanisms by developing a regime-wide ‘facilitation index’. The index is based on five components: de minimis, diagonal cumulation, full cumulation, drawback, and self-certification. The maximum index value of 5 results when the permitted level of de minimis is 5 per cent or higher and when the other four variables are permitted by the RoO regime in question.

Figure 3.3 graphs the ‘facil index’ values for PTAs. The PANEURO and NAFTA models are nearly on a par; the difference here is produced by coding NAFTA as allowing drawback, as it did for the first seven years. The EU–South Africa and the Canada–Israel are the most ‘permissive’ regimes, the former thanks to drawback and diagonal and full cumulation, and the latter because of self-certification, drawback and cumulation with any of the party’s common FTA partners. Meanwhile, many regimes with an across-the-board RoO neither provide for
### Table 3.5 Sectoral restrictiveness of sectoral RoO in selected PTAs

<table>
<thead>
<tr>
<th>HS Section</th>
<th>PAN–EURO</th>
<th>EFTA–MEX</th>
<th>NAFTA</th>
<th>US–Chile</th>
<th>CAFTA</th>
<th>CR–MEX</th>
<th>G–3</th>
<th>Chile–CACM</th>
<th>JSEPA</th>
<th>Chile–Korea</th>
<th>SADC</th>
<th>Non-pref. avg.</th>
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<td>1. Live Animals</td>
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<td>5.3</td>
<td>6.0</td>
<td>6.0</td>
<td>6.0</td>
<td>5.4</td>
<td>5.9</td>
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<td>6.0</td>
<td>7.0</td>
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<td>2. Vegetable Products</td>
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*Source: Authors’ calculations on the basis of codes generated per methodology in Appendix I.*
Fig. 3.3 Facilitation index for selected PTAs.

Source: Authors’ calculations on the basis of coding scheme above.
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*de minimis* nor feature many regime-wide provisions of flexibility; the most usually occurring regime-wide rule in these PTAs is drawback. Indeed, that regimes with the most stringent RoO and the highest degree of sectoral selectivity in RoO feature the highest facilitation values may evince counterlobbying by producers jeopardized by stringent product-specific RoO.

### 3.5 RoO ‘innovations’: *ad hoc* mechanisms for flexibility

This section provides a look at some further dimensions of RoO regimes that go beyond the more traditional and prevalent components included in the restrictiveness and facilitation indices in this study, but that alleviate the impact of stringent RoO: (1) a phase-in period for a stringent value content RoO; (2) permanent deviations for a country or a set of countries from the RoO regime that would otherwise apply; (3) flexibility in the ways of calculating value content; and (4) tariff preference levels (TPLs) employed when the partner lacks intermediate product industries. While most regimes employing these provisions make them applicable to all members, some regimes provide them asymmetrically, for instance to accommodate some country-specific idiosyncrasies in production structures or to provide greater leniency to a developing member country when the parties’ development levels differ. These provisions can be of great importance particularly to countries with limited production base and/or in the absence of relatively cheap inputs and production processes in the PTA area.

#### A. RoO phase-ins

Some regimes have adopted what are in many cases highly detailed product-specific provisions that allow for phasing in of the RoO. Mercosur–Chile FTA provides a seven-year adjustment period for Paraguay to start applying the FTA’s import content RoO of 40 per cent in selected headings across a host of sectors such as food products, chemicals, plastics, textiles, apparel, footwear, base metals, and machinery. During the period, Paraguay applies a 60 per cent import content rule. Mercosur–Bolivia FTA allows Bolivia to export to Mercosur some selected goods at 50 per cent import content for the first five years, and others at 60 per cent for three years as opposed to the 40 per cent that will subsequently take effect. For its part, Paraguay can export to Bolivia at 60 per cent import content for the first three years.
Also, the EU’s extra-European agreements with Mexico and Chile allow for some product-specific deviations from the PANEURO standard for a certain period of time.\(^\text{22}\) In the case of the EU–Mexico FTA, these pertain to one whole chapter (knitted apparel) and to 25 headings (or subheadings) in chemicals, textiles, footwear, machinery, and vehicles, and endure from two to six years prior to converging to the benchmark RoO. In footwear, the RoO is more restrictive for the EU than in its other FTAs: the same RoO applies as in the FTAs with Chile and South Africa up to a certain quota, while the rest of the EU exports to the Mexican market are regulated by much more stringent RoO. The RoO phase-ins are fewer in the case of the EU–Chile FTA, pertaining to textiles and bicycles for the first three years of the agreement.

### B. Permanent reductions in the level of RVC

A second means to add leniency to the RoO protocol are permanent deviations for a country or a set of countries from the RoO regime that would otherwise apply. The RoO of the Andean Community allows the less-developed members, Bolivia and Ecuador, to use non-originating components up to 60 per cent of the value of the final good, as opposed to the 50 per cent applicable to the other members. LAIA allows the less-developed partners to use non-originating components of up to 60 per cent of the value of the final good, as opposed to 50 per cent applying to the rest of the members. In COMESA, products of importance to economic development to the partners (selected headings in mineral products, chemicals, machinery, and optical instruments) enjoy a 25 per cent RVC, as opposed to the across-the-board 35 per cent RVC that otherwise applies.

Also, the EU–Mexico and EU–Chile FTAs allow for permanent deviations from the single list, PANEURO model. The deviations are rather minor and apply only to selected industrial products.\(^\text{23}\) Nonetheless, they indicate that Mexico and Chile did achieve some favorable sectoral outcomes in the RoO bargaining with the EU.

### C. Options for calculating value content

Some regimes have created innovative optional means of calculating value content. In SADC, the more-developed members may allow the less-developed members to count as originating processes that are usually left outside the value-content calculation. Regimes modelled after NAFTA

\(^{22}\) For a detailed treatment, see Estevadeordal and Suominen (2003).

\(^{23}\) See Estevadeordal and Suominen (2003).
provide a number of optional ways of calculating RVC in vehicles when
the producer uses pre-defined intermediate goods from chapters 40 and
84, as well as for calculating the RVC for these intermediate goods.24

However, it is Singapore’s FTAs that incorporate perhaps the most
innovative and comprehensive mechanisms to add flexibility to the
calculation of the value content. These are designed to help the many
Singaporean industries that have extensive outsourcing ties especially in
South-East Asia to qualify for the preferential treatment provided by its
FTA partners. The two key mechanisms are outward processing (OP) and
integrated sourcing initiative (ISI). OP is recognized in all of Singapore’s
FTAs, while ISI is incorporated in the US–Singapore FTA. The concept of OP
enables Singapore to outsource part of the manufacturing process, usually
the lower value-added or labor-intensive activities, to the neighboring
countries, yet to count the value of Singaporean production done prior to
the outsourcing activity toward local, Singaporean content when meeting
the RoO required by the export market. Table 3.6 illustrates the process.

Although the OP concept applies only to products with a value-added
rule, it is credited to have encouraged outsourcing of labor-intensive and
low-value processes and retaining higher-value activities in Singapore.

For its part, ISI operating in the US-Singapore FTA applies to non-
sensitive, globalized sectors, such as information technologies. Under the
scheme, certain IT components and medical devices are not subject to
RoO when shipped from either of the parties to the FTA partner. ISI is
designed to reflect the economic realities of globally distributed produc-
tion linkages, and to further encourage US multinationals to take
advantage of outsourcing opportunities in the ASEAN countries.

D. Tariff Preference Levels

The fourth ad hoc mechanism to add leniency to a RoO regime is Tariff
Preference Levels (TPLs). TPLs allow goods that would not otherwise
satisfy the RoO protocol to qualify for the preferential treatment up to

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24 The producer of a vehicle can calculate the RVC by averaging the calculation over the
fiscal year by using any one of the following categories: (a) the same model line of vehicles in
the same class of vehicles produced in the same plant in the territory of a party; (b) the same
class of motor vehicles produced in the same plant in the territory of a party; and (c) the same
model line of motor vehicles produced in the territory of a party. Meanwhile, the producer
can calculate the RVC intermediate goods for vehicles by (a) averaging the calculation over
the fiscal year of the motor vehicle producer to whom the good is sold, over any quarter or
month, or over its fiscal year, if the good is sold as an aftermarket part; (b) calculating the
average separately for any or all goods sold to one or more motor vehicle producers; or (c)
calculating separately those goods that are exported to the territory of the other party.
some pre-specified annual quotas. Above these levels, non-originating goods become subject to the importer’s MFN tariff. Most commonly applying to textiles and apparel, TPLs are employed particularly in the NAFTA-model RoO regimes. They are generally extended by all parties to all other parties, made available by any given party on a ‘first-come, first-served’ basis.

NAFTA provides TPLs for such non-originating products as cotton and manmade fiber apparel, wool apparel, manmade fiber fabrics, and fiber spun yarn. Depending on the product category, they reach up to 80 million square meters equivalent (SMEs) for Canadian and 45 million SMEs for Mexican exports to the US market, and 12 million for selected US exports to Mexico. The most recent RoO regime signed by the US, CAFTA, offers TPLs for only two of the Central American countries, Costa Rican and Nicaragua, and phases them out quickly. In the case of Costa Rica, TPLs are set at 500 000 SMEs, limited to wool, and due to expire in two years. Nicaragua’s TPLs start at 100 million SMEs and are phased out in equal annual cuts over five years.

Still other regimes employ what could be viewed as a modified form of TPLs, allocating the quotas not fully free of RoO, but against some more lenient product-specific RoO. For instance, SADC provides quotas at more lenient RoO for the textile and apparel exports of Malawi, Mozambique, Tanzania, and Zambia (MMTZ countries) to the SACU region for a period of five years.

### 3.6 Policy recommendations: counteracting restrictive RoO and the splintering of the global RoO panorama

While RoO are not necessarily bad for sound economic decisions, restrictive RoO can be. Furthermore, the existing differences in the product-specific and regime-wide RoO across the different RoO regimes can even in a simplified bi- or tripolar RoO world make a difference in
Mapping and measuring Rules of Origin around the world

economic decisions and limit exporters’ opportunities for diversifying markets.

How can the potential frictions created by stringent RoO and cross-regime differences in RoO be reduced? How can entrepreneurs import inputs from the cheapest sources, firms exploit cross-border economies of scale at lowest costs, and multinational companies make sweeping investment decisions based on economic efficiency rather than distortionary policies? What are the best ways to counter the development of trade- and investment-diverting hubs in favor of a globally free flow of goods, services, and investment?

Abolishing RoO altogether would certainly be the best and simplest means to counteract the impact of RoO. Another way to relegate RoO to irrelevance is by bringing MFN tariffs to zero globally. However, since these options are hardly politically palatable in the near future, a third possibility is to harmonize preferential RoO at the global level. Establishing a small set of RoO combinations—a ‘RoO band’—would be a good start. This would ensure that at least the required production methods in a given sector would remain relatively similar across export markets—and enhance the prospects of linking agreements with each other in the future. Measures to accompany the harmonization work could involve (1) the incorporation of the various mechanisms of flexibility to RoO regimes during the transition to a global RoO regime; and (2) the establishment of a multilateral mechanism to monitor the member states’ implementation of preferential and non-preferential RoO.

To be sure, harmonization would not be a simple endeavor given the differences in the types of RoO around the world. Even slight differences can be difficult to overcome due to political resistance by sectors benefiting from status quo. Meanwhile, it is not clear that a strong global exporter lobby would materialize to voice demands for harmonization. Perhaps most importantly, both the EU and the US would likely in principle be reluctant to adopt each other’s RoO. Both parties would likely also be concerned of the counterpart’s striving for a RoO regime that would allow it to trans-ship via the parties’ common PTA partners, such as Mexico, to the other party’s market.

However, adopting global regulations for preferential RoO regimes is not necessarily all that daunting. There are five sources of optimism.

First, the WTO members have already been able to sit down and compromise on harmonized non-preferential RoO, which not only evinces a reservoir of political will to tackle RoO, but also provides an immediately
available blueprint for harmonizing preferential RoO. And not only are non-preferential RoO negotiated and readily available as a model, but they make a good model: overall, they are less restrictive and complex than either the NAFTA- or PANEURO-type RoO.

Secondly, preferential RoO would likely prove easier to negotiate than non-preferential RoO. Non-preferential RoO involve tracking the production process all the way to the country in which the good originates, while preferential RoO simply require a determination that the final exporter country is also the country of origin: the good either originates in the PTA area or it does not, with the ‘true’ and very initial origin being immaterial. Preferential RoO talks would thus likely engage a smaller number of interested parties to contest a given rule. Moreover, unlike non-preferential RoO that are employed in the application of numerous other trade-policy instruments, preferential RoO have few purposes beyond refereeing the market access of goods to the PTA space. As such, their negotiation would probably not involve as much consideration of the other WTO agreements as the harmonization of non-preferential RoO does.

Thirdly, the growing attention at the WTO on PTAs in general and preferential RoO, in particular, should propel constructive proposals as to the types of RoO that are most conducive to the march toward unfettered global flow of commerce. For the first time in its history, the WTO Committee on Regional Trade Agreements (CRTA) has decided to consider RoO a ‘systemic’ issue, as opposed to both individual PTA issues such as prior considerations of the PANEURO system, and issues that—whether systemic or individual—are not being prioritized by the CRTA.

Fourthly, advances in Trade-Related Investment Measures (TRIMS) can help advance the harmonization of RoO, if RoO are viewed, as they rightfully can and should be, as policy instruments affecting investment decisions (Thorstensen 2002). Like TRIMS, RoO can be employed strategically as an incentive to attract investment and encourage exports—and exports with high local value. A sturdier multilateral regulatory framework on investment policies could help curb the strategic, trade- and investment-distorting uses of RoO.

Harmonization of preferential RoO—and harmonization toward a flexible-regime model—provides at present the most attainable means to counteract RoO’s negative effects on global trade and investment. The negotiators of the Doha Trade Round should decisively tackle RoO as a distortionary trade and investment policy instrument, and do so in four concrete ways.
First, they should provide a forceful push for completing the task of harmonizing non-preferential RoO. Completing the harmonization process is all the more compelling in the face of the growth of global commerce and the increasing fragmentation of global production, both of which would thrive under a clear and uniform set of rules.

Secondly, the Doha negotiators should launch a process of de jure harmonization of preferential Rules of Origin. The relatively high levels of restrictiveness of the main RoO regimes and the differences between regimes pose unnecessary policy hurdles to rational economic decisions, limiting the opportunities for exporters to operate on multiple trade fronts simultaneously, and hampering consumers’ access to the best goods at the lowest prices.

Thirdly, the Doha Round should forge in a multilateral mechanism to monitor and enforce the transparent application of both preferential and non-preferential RoO. And fourthly, RoO should be incorporated in the TRIMs negotiations.

Preferential RoO matter only as long as there are MFN tariffs. Thus, the ultimate key to counteracting preferential RoO’s negative effects lies in the success of multilateral liberalization. Should multilateral trade rounds result in deep MFN tariff lowerings and the proliferation of PTAs engender a dynamic of competitive liberalization worldwide, the importance of preferential RoO as gatekeepers of commerce would automatically dissolve.

3.7 Conclusion

This chapter has sought to present a novel descriptive and analytical mapping of the global Rules of Origin panorama. We have (1) reviewed the types of RoO used around the world; (2) drawn comparisons between the structure of RoO across a host of PTAs; (3) presented methodologies for constructing generalizable measurements for (a) the degree of restrictiveness and selectivity of product-specific RoO, and (b) the level of flexibility provided by the various regime-wide RoO; and (4) explored the behavior of RoO over time. We have also sought to chart some of the main ad hoc measures in RoO regimes, and offer policy recommendations for reducing the actual restrictiveness of RoO and the proliferation of divergent types of RoO regimes around the world.

We have provided precursory evidence that RoO are to an important extent driven by political-economy dynamics. The analytical tools
developed here can be employed to evaluate the politics behind the definition of RoO as well as the economic effects of RoO. On a broader level, we have striven to help pave the way for further efforts to disaggregate PTAs by the various disciplines they prescribe. Such a task is central for developing a full understanding of the extent of contractual diversity in the rapidly proliferating PTA universe. It is also crucial for moving the debate on the effects of PTAs on the multilateral trading system toward PTA-PTA comparisons—and, ultimately, for making recommendations for designing PTAs in ways that are conducive to unfettered global commerce.

References


Mapping and measuring Rules of Origin around the world


Appendix I

The observation rule yields a RoO index as follows:

\[ y = 1 \text{ if } y^* \leq CI \]
\[ y = 2 \text{ if } CI < y^* \leq CS \]
\[ y = 3 \text{ if } CS < y^* \leq CS \text{ and } VC \]
\[ y = 4 \text{ if } CS \text{ and } VC < y^* \leq CH \]
\[ y = 5 \text{ if } CH < y^* \leq CH \text{ and } VC \]
\[ y = 6 \text{ if } CH \text{ and } VC < y^* \leq CC \]
\[ y = 7 \text{ if } CC < y^* \leq CC \text{ and } TECH \]

where \( y^* \) is the latent level of restrictiveness of RoO (rather than the observed level of restrictiveness); CI is change of tariff classification at the level of tariff item (8–10 digits), CS is change at the level of subheading (6-digit HS), CH is change at the level of heading (4 digits), and CC is change at the level of chapter (2 digits HS); VC is a value-content criterion; and TECH is a technical requirement.

We make three modifications to the observation rule in the case of RoO for which no CTC is specified in order to allow for coding of such RoO in the PANEURO, SADC and other regimes where not all RoO feature a CTC component. First, RoO based on the import content rule are equated to a change in heading (value 4) if the content requirement allows up to 50 per cent of non-originating inputs of the ex-works price of the product. Value 5 is assigned when the share of permitted non-originating inputs is below 50 per cent, as well as when the import content criterion is combined with a technical requirement. Secondly, RoO featuring an exception alone is assigned the value of 1 if exception concerns a heading or a number of headings, and 2 if the exception concerns a chapter or a number of chapters. Thirdly, RoO based on the wholly obtained criterion are assigned value 7.

To be sure, the observation rule is somewhat crude (1) for accounting for the restrictiveness of a standalone TECH RoO, which is likely more demanding than a coding of 1–2 allows; and (2) for capturing subtleties of the EU RoO as it does not account for the ‘soft’ CTC criterion used by the EU. However, it does allow for establishing useful cross-regime comparisons.
## Mapping and measuring Rules of Origin around the world

### Appendix IIa PTAs around the world, by year of entry into force and full name

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Notes for tables

Ex-works price means the price paid for the product ex works to the manufacturer in the Member States in whose undertaking the last working or processing is carried out, provided the price includes the value of all the materials (the customs value at the time of importation of the non-originating materials used, or the first ascertainable price paid for the materials in the member state concerned) used, minus any internal taxes that are, or may be, repaid when the product obtained is exported.
The transaction method is:

\[
RVC = \left( \frac{TV - VNM}{TV} \right) \times 100,
\]

where RVC is the regional value content, expressed as a percentage; TV is the transaction value of the good adjusted to a FOB basis; and VNM is the value of non-originating materials used by the producer in the production of the good.

The net cost method is

\[
RVC = \left( \frac{NC - VNM}{NC} \right) \times 100,
\]

where RVC is the regional value content, expressed as a percentage; NC is the net cost of the good; and VNM is the value of non-originating materials used by the producer in the production of the good.

The build-down method is

\[
RVC = \left( \frac{AV - VNM}{AV} \right) \times 100;
\]

the build-up method is:

\[
RVC = \left( \frac{VOM}{AV} \right) \times 100,
\]

where RVC is the regional value content, expressed as a percentage; AV is the adjusted value; VNM is the value of non-originating materials used by the producer in the production of the good; and VOM is the value of originating materials used by the producer in the production of the good.

The initial VC for chs. 28–40 is 40 per cent for the first three years, 45 per cent during the fourth and fifth years, and 50 per cent starting in year six. For chs. 72–85 and 90, VC is 50 per cent for the first five years, and 55 per cent starting year six.

The Mercosur RoO is 60 per cent RVC, and, additionally, change in tariff heading (Garay and Cornejo 2002). When it cannot be determined that a change in heading has taken place, the CIF value of the non-originating components cannot exceed 40 per cent of the FOB value of the final good. Special RoO apply to selected sensitive sectors, including chemical, some information technology, and certain metal products.

The requirement is that the CIF value of the non-originating materials does not exceed 40 per cent of the FOB export value of the final good.

A 50 per cent MC rule applies to Colombia, Peru and Venezuela; products from Bolivia and Ecuador are governed by a 60 per cent MC rule.

The value-added test is based on the formula: Qualifying Expenditure (Q/E)/Factory Cost (F/C), where Q/E = Qualifying expenditure on materials + qualifying labor and overheads (includes inner containers); and F/C = Total expenditure on materials + qualifying labor and overheads (includes inner containers). The factory or works cost are essentially the sum of costs of materials (excluding customs, excise or other duties), labor, factory overheads, and inner containers.

The agreement requires the value added ensuing from their production in member states be not less than 40 per cent of their final value 'at the termination of
the production phase’. In addition, the share owned by the citizens of the member states of the producing plant cannot be less than 51 per cent.

\[ \text{NOM} = \left( \frac{\text{MCIF}}{\text{FOB}} \right) \times 100, \]

where NOM is the value content of non-originating materials, MCIF is the CIF value on non-originating materials, and FOB is the free on-board value payable by the buyer to the seller.

The origin protocol requires that either the CIF value of non-originating materials does not exceed 60 per cent of the total cost of the materials used in the production of the goods; or that the value added (the difference between the ex-factory cost of the finished product and the CIF value of the materials imported from outside the member states and used in the production) resulting from the process of production accounts for at least 35 per cent of the ex-factory cost (the value of the total inputs required to produce a given product) of the goods.

Besides the 40 per cent RVC rule, the share of member states’ citizens of the plant that produced the product must be at least 51 per cent.

The RVC is calculated as the sum of (i) the cost or value of the materials produced in the exporting Party, plus (ii) the direct costs of processing operations performed in the exporting party. It cannot be less than 35 per cent of the appraised value of the article at the time it is entered into the other party.

The cost or value of materials produced in a party includes: (i) the manufacturer’s actual cost for the materials, (ii) when not included in the manufacturer’s actual cost for the materials, the freight, insurance, packing, and all other costs incurred in transporting the materials to the manufacturer’s plant, (iii) the actual cost of waste or spoilage (material list), less the value of recoverable scrap, and (iv) taxes and/or duties imposed on the materials by a party, provided they are not remitted upon exportation. When a material is provided to the manufacturer without charge, or at less than fair market value, its cost or value shall be determined by computing the sum of: (i) all expenses incurred in the growth, production, or manufacture of the material, including general expenses, (ii) an amount for profit, and (iii) freight, insurance, packing, and all other costs incurred in transporting the material to the manufacturer’s plant.

Direct costs of processing operations mean those costs either directly incurred in, or that can be reasonably allocated to, the growth, production, manufacture, or assembly, of the specific article under consideration. Such costs include, for example, (i) all actual labor costs involved in the growth, production, manufacture, or assembly, of the specific article, including fringe benefits, on-the-job training, and the cost of engineering, supervisory, quality control, and similar personnel, (ii) dies, molds, tooling and depreciation on machinery and equipment that are allocable to the specific article, (iii) research, development, design, engineering, and blueprint costs insofar as they are allocable to the specific article; and (iv) costs of inspecting and testing the specific article.
Drawback is not mentioned in Hungary–Israel, Poland–Israel, Slovenia–Croatia, Slovenia–FYROM FTAs. Drawback allowed for the first two years in EU–Palestinian Authority, two and one half years in EFTA–Palestinian Authority, three years in EFTA–FYROM, one year in Bulgaria–FYROM, three months in Turkey–FYROM, and two years in Israel–Slovenia.

Joint Declaration I of the FTA opens the possibility for full cumulation, stating that ‘or that purpose, the Parties will examine the parameters to be considered in evaluating the economic conditions needed to eventually implement full cumulation. This process will begin no later than three years after entry into force of this Decision.’

The Revised Treaty of Chaguaramas Establishing the Caribbean Community, including the CARICOM Single Market and Economy stipulates that any member state needs to justify the need to apply an export drawback Council for Trade and Economic Development (COTED). COTED is mandated to review the use of drawback by members on an annual basis.

When products from the South Pacific Islands that are exported to New Zealand are cumulated with Australian inputs, a minimum of 25 per cent of ‘qualifying expenditure’ from South Pacific Islands is required.

Requires the expenditure on goods produced and labor performed within the territory of the exporting member state in the manufacture of the goods to not less than 50 per cent of the ex-factory or ex-works cost of the goods in their finished state.

The agreement stipulates that ‘With respect to drawbacks within one year from the date of entry into force of this Agreement, the Standing Committee shall consider whether drawbacks on goods imported from third countries should be permitted in relation to products used in the manufacture of finished products for which concessions have been exchanged by the Participating States.’

Mentioned in the section on trade remedies. One of the criteria for imposing a countervailing duty is that the targeted subsidy is not less than the 2 per cent de minimis.

The FTA stipulates that ‘Where each Party has entered separately into a free trade agreement under Article XXIV of the GATT 1994 with the same non-Party before this Agreement enters into force, a good, which, if imported into the territory of one of the Parties under such free trade agreement with that non-Party, would qualify for tariff preferences under that agreement, shall be considered to be an originating good under this Chapter when imported into the territory of the other Party and used as a material in the production of another good in the territory of that other Party.’
5

Rules of Origin as export subsidies*

Olivier Cadot, Antoni Estevadeordal, and Akiko Suwa-Eisenmann

5.1 Introduction

With the proliferation of preferential trading agreements over the last two decades, considerable attention has been devoted to assessing their effect on market access. Notwithstanding the fact that GATT Article XXIV, para. 8(b) requires the removal of trade barriers on ‘substantially all trade’ in Free-Trade Agreements (FTAs), in reality numerous barriers to intrabloc trade are often left intact or even erected as part of the agreements. Rules of Origin (RoOs) feature prominently among those barriers.

In principle, RoOs are meant to prevent the trans-shipment of goods imported from the rest of the world, via member states with low external tariffs, into those with higher ones. In practice, these rules often have the effect of ‘exporting protection’ from high-tariff members to low-tariff ones, as pointed out by Krishna and Krueger (1995) and Krueger (1997).

In North-South FTAs, in particular, the combination of tariff preferences and RoOs can affect trade flows in ways that are not conducive to economic efficiency. Suppose that the production of final goods involves two stages: the capital-intensive production of components, and labor-intensive assembly. If goods are entirely produced in the North early on

* This research was produced as part of an IDB research program. We are thankful to Celine Carrere, Jon Haveman, Jim de Melo, Marcelo Olarreaga, Pablo Sanguinetti, Maurice Schiff, and participants at the IIIrd Workshop of the Regional Integration Network, Punta Del Este, December 2003, the joint IDB/CEPR workshop, Paris, April 2003, the IDB/CEPR/INRA/DELTA conference, Washington, February 2004, and a seminar at GREQAM, University of Aix, for useful comments and suggestions on previous versions. All errors remain ours, and the views expressed in this chapter do not necessarily reflect those of the institutions to which the authors are affiliated. Special thanks go to Kati Suominen and to David Colin for superb research assistance.

1 See Serra et al. (1996) for a review of shortcomings in the application of Article XXIV.
in their product cycle, preferential tariff reductions may accelerate the process of assembly relocation in the South, leading to what Hanson (1996) called ‘regional production networks’.\(^2\) Suppose, however, that component manufacturing could profitably be relocated to another Northern country outside of the preferential trading bloc. Rules of Origin, by forcing Southern assemblers to source a minimum fraction of their components in the area, prevent the ultimate relocation of the whole value chain in the world’s most efficient location. In other words, RoOs, when they bind, organize trade diversion by creating captive markets for relatively inefficient Northern intermediate-good producers.

While the potentially trade-diverting effect of RoOs has been widely recognized in the literature (see, for instance, Falvey and Reed, 2000), the recent political-economy literature has also highlighted the fact that RoOs can sometimes make preferential agreements politically feasible in circumstances where they wouldn’t be otherwise (Duttagupta, 2000; Duttagupta and Panagariya, 2002). As Grossman and Helpman (1995) showed that trade-diverting FTAs are, \textit{ceteris paribus}, more likely than others to be politically acceptable, Duttagupta and Panagariya’s result is quite consistent with RoOs acting as ‘trade diverters’.

While the theoretical analysis of RoOs has made considerable strides since Krueger’s pioneering work, their empirical analysis is still in its infancy, partly because their complex legal nature makes measurement difficult. Estevadeordal (2000) recently proposed a way of overcoming this difficulty by devising a qualitative index of RoO strictness. Using the fact that most RoOs are—at least in recent agreements—expressed as a required change in tariff heading at various levels of aggregation, Estevadeordal’s index takes values that increase in the level of aggregation of the required change, the idea being that a change at a more aggregate level is ‘wider’ and hence a more stringent transformation requirement. On the basis of his index, he identified a strong negative effect of NAFTA’s RoOs on Mexican market access. Using the same index, Anson \textit{et al.} (2003) showed that the effect of NAFTA’s tariff preferences is systematically reduced by RoOs.

Although Anson \textit{et al.’s} results are qualitatively unambiguous, they suffer from the fact that the potential endogeneity of RoOs is not treated. If there is little doubt that, as pointed out by Estevadeordal (2000) and

\(^2\) However, Hanson also shows that the emergence of vertical trade between Mexico and the United States largely pre-dates the formation of NAFTA, as assembly plants operating under the older ‘maquiladora’ regime already accounted for 53\% of Mexico’s manufactured exports in 1992.
Sanguinetti (2003), RoOs are the result of a political bargaining process that is itself likely to be affected by trade patterns, it is not entirely clear, short of a full political-economy model, what exactly they are endogenous to. If they are endogenous to Mexican final-good exports, clearly there is a simultaneity problem. If, however, RoOs are endogenous to trade flows that are related to Mexican exports only through an indirect, non-linear relationship, for estimation purposes the relevant system may be recursive rather than truly simultaneous.

In this chapter, we take the endogeneity problem as a starting point for an exploration of the political-economy forces that are likely to shape RoOs. Although many assumptions must be made along the way, we show that in a model of endogenous RoO determination à la Grossman–Helpman (1994), the key determinant of RoOs in terms of trade flows is a product of US intermediate-good exports to Mexico and input-output coefficients. The model generates results both in terms of interpretation of what RoOs do and in terms of what the estimation strategy should be.

As for interpretative results, the key one is that whereas RoOs create captive markets for US intermediate goods, tariff preferences needed to make them acceptable to Mexican exporters along their participation constraint constitute a transfer—albeit a modest one—from US taxpayers.³ The combination of RoOs and tariff preference is then equivalent to an export subsidy on US intermediate goods. The model thus proposes a tentative answer, in this particular context, to a question arising frequently in trade policy—namely, why inefficient indirect instruments are used to redistribute income or favor particular activities when more direct instruments would achieve the same results at lower welfare costs. Here, RoOs substitute for a prohibited instrument, as export subsidies would be in violation of the US’s obligations under the GATT.

Our analysis of Rules of Origin requires a model with multiple stages of production. In contrast to Lloyd (1993), Rodriguez (2001) and Carrère and de Melo (2004) who use a multistage production model due to Dixit and Grossman (1982), our analysis requires only a two-stage Leontieff production technology whose analytics are very simple.

As for the estimation, the model suggests, as the key determinant of NAFTA’s RoOs, a vector product of input-output coefficients multiplied by US intermediate-good exports upstream of the good to which RoOs apply. Our estimation strategy thus consists of regressing RoOs on steady-state

³ By participation constraint, we mean that the rate of effective protection granted to Mexican final-good producers by the combination of tariff preferences and Rules of Origin is just zero.
Rules of Origin as export subsidies

tariff preferences (equal, at the end of the phase-out period, to the US MFN tariff adjusted for exceptions) and the upstream variable just described, the functional form being the political-economy model’s first-order condition. This generates a vector of predicted RoOs that are then used in the market-access equation. As for tariff preferences, we do not model their endogeneity directly as intra-NAFTA tariffs smoothly converge to zero over a fixed phase-out period. A fuller model would recognize, as Estevadeordal (2000) did, that the length of the phase-out may itself be endogenous, but the model we use does not lend itself easily to taking this into account.

NAFTA, on which we test the model’s main predictions, is a good testing ground for the effect of RoOs. It is the quintessential example of the North-South agreement due to the comprehensive tariff liberalization built in the agreement and the fact that member countries share borders, eliminating the need to account for distance as in traditional gravity exercises. From 1989 to 1994, Mexico’s exports to the United States benefitted from the Generalized System of Preferences (GSP), after which this regime was overhauled by NAFTA. We construct a panel dataset with information dating back to 1994 on commodity exports from Mexico to the United States under different preferential programs. The data was compiled mostly from USITC sources at the 6-digit HS disaggregation level and contains information on tariff preferences (GSP and NAFTA rates) granted by the United States to Mexico. The data on Rules of Origin comes from Estevadeordal (2000).

The results are in striking conformity with the model’s predictions. All variables are significant—most of them at the 1% level—and have the expected signs. Tariff preferences and RoOs exert positive and negative influences respectively on Mexican exports, and the key variable influencing endogenously determined RoOs—a product of input-output coefficients and US intermediate exports to Mexico—has the predicted sign and is significant at the 1% level.

The chapter is organized as follows. Section 5.2 sets out the political-economy model and characterizes its equilibrium. Section 5.3 presents the empirical methodology and results, and Section 5.4 concludes.

5.2 Politically determined RoOs

This section uses a simple, stripped-down political-economy model to illustrate the simultaneous determination of tariff preferences and RoOs. Although the model borrows from Grossman and Helpman (1994) the
appearance of a general-equilibrium model, it is best thought of as a partial-equilibrium one as interindustry linkages are non-existent except for the vertical linkages around which the discussion is centered.

5.2.1 The economy

Consider a PTA formed by two small economies, North (N) and South (S). The North produces, under increasing cost, an intermediate good denoted by the subscript I and exports it to the South that uses it to assemble a final good denoted by the subscript F. Southern supply of the final good is not enough to cover the North’s consumption at its tariff-ridden price, so the North also imports from the rest of the world. The South imports all its own consumption of the final good from the rest of the world and exports all its production to the North.4

Households in both countries consume the final good and an aggregate of all other goods, which also serves as numeraire, under identical and quasilinear preferences. Let \( c_F \) and \( c_0 \) denote, respectively, the quantities of final and ‘other’ goods consumed by a representative consumer in either country. The utility function is

\[
U = c_0 + u(c_F),
\]

where \( u' > 0 \) and \( u'' < 0 \).

The final good sold in the free-trade area is produced by combining value added and the intermediate good. Value added is created with intersectorally mobile labor \( \ell \) and specific capital \( \kappa \) under a technology \( f(\ell, \kappa) \). The technology producing the final good, into which the value-added production function is nested, is of the Leontief type with input-output coefficient \( a_{IF} \). Letting \( y_F \) and \( x_I \) stand, respectively, for the final-good output and quantity of intermediate good consumed in the process,

\[
y_F = \min\{f(\ell, \kappa); x_I / a_{IF}\}. \tag{5.2}
\]

Let \( p^*_I \) and \( p^*_F \) be, respectively, the intermediate and final goods’ world prices. Under free trade, given the technology postulated, the ‘net price’ out of which a Southern producer can remunerate value added (wages and profits) is

\[
p^* = p^*_F - a_{IF} p^*_I. \tag{5.3}
\]

With the stock of specific capital fixed, the technology \( f \) that generates value added displays diminishing returns on labor. The supply of value

4 This is shown to arise endogenously as a result of tariff preferences, perfect competition, and the non-market saturation assumption in Cadot et al. (2001).
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added is therefore upward sloping in its net price \( p^* \), and economic rents accrue to owners of specific capital, who are assumed to be the industry’s residual claimants.

A similar good is sold in the rest of the world, and the marketing mix between the free-trade area and the rest of the world is determined by a Constant Elasticity of Transformation (CET) technology (see the footnote in Section 5.3) that provides the functional form for the market-access equation estimated in the empirical part.

The rest of the economy uses only labor under constant returns to scale, which fixes the wage rate. Given this assumption, the model becomes a quasi-partial equilibrium one. In this setting, the Southern final-good producers’ surplus under free trade, \( \pi_F^* \), is a monotonic increasing function of \( p^* \):

\[
\pi_F^* = p^* y_F - w_S \ell_F.
\]

Letting \( p \) be the domestic net price, \( (p - p^*)/p \) is the effective rate of protection granted to Southern producers when selling on the Northern market.\(^5\)

The intermediate good is produced in the North with ‘value added only’ (no intermediate consumption) under a technology similar to \( f \) (i.e. a CRS combination of labor and specific capital). Letting \( y_I \) be its output, the producer surplus is

\[
\pi_I = p_I y_I - w_N \ell_I.
\]

Finally, we will treat the intermediate-good’s supply elasticity in the North, \( \varepsilon \equiv p_I y_I / y_I \), as a constant.

5.2.2 The preferential regime

In order to keep things simple, we will treat MFN (external) tariffs on the final and intermediate goods as pre-determined to the PTA and hence parametric. Northern tariffs are, respectively, \( t^N_F \) and \( t^N_I \) and Southern ones \( t^S_F \) and \( t^S_I \). In order to focus on the effects of Northern tariffs and RoOs, we will set \( t^S_F = t^S_I = 0 \). Extensions to other cases are straightforward but add little to the analysis.\(^6\)

\( ^5 \) To see this, it suffices to observe that \( p \) is unit value added.

\( ^6 \) First, note that endogenous determination of MFN tariffs would yield \( t^S_F = t^S_I = 0 \) given that the South does not produce the intermediate good and the North does not produce the final one. However, if specialization is a result of the PTA and MFN tariffs are pre-determined to it (say, because they are negotiated in multilateral rounds and thus constitute valuable bargaining chips), they will not be eliminated after the PTA’s formation.
The model’s endogenous political-economy variables are the preferential tariff applied, as part of the PTA, on Southern exports of the final good, \( \tau \), and the regional value content of the RoO, \( r \). Let \( x^N_I \) be the amount of intermediate good sourced in the North (as opposed to imported from the rest of the world), and let \( \delta = t^N_F - \tau \) be the rate of preference (in specific form). The price at which Southern final-good producers—we will henceforth use the term ‘assemblers’ for brevity—can sell in the North is

\[
\begin{align*}
p_F = \begin{cases} 
p^*_F + \delta & \text{if } x^N_I \geq r x_I \\
p^*_F & \text{otherwise.}
\end{cases}
\end{align*}
\] (5.5)

That is, Southern assemblers can sell under the PTA’s preferential regime if they satisfy the RoO. If not, they sell under the MFN regime, i.e. at the world price.

Given the RoO, Southern assemblers selling under the preferential regime source a proportion \( r \) of their intermediate good in the North. The price of the ‘composite’ intermediate good is thus \( r p_I + (1 - r) p^*_I \), and the net price faced by Southern assemblers is

\[
p = p^*_F + \delta - a_{IF} [r p_I + (1 - r) p^*_I].
\] (5.6)

5.2.3 The politics

We assume no bargaining between the Northern and Southern partners: the North makes a take-it-or-leave-it offer to the South that the South accepts as long as its participation constraint is not violated. This is admittedly a rather crude description of negotiations between Northern and Southern preferential partners but perhaps not an unrealistic one judging from ample anecdotal evidence about US-Mexico or EU-Eastern Europe negotiations.

Thus, the political action is in the North, where the RoO’s RVC content \( r \) and the rate of preference \( \delta \) are simultaneously determined. Our analysis is concerned with a transition phase during which preferences are partial. In the long run, after intrabloc tariffs have been phased out the rate of preference is automatically equal to the rate of MFN tariffs, so the participation constraint suffices to determine the RoO’s RVC content. During

Secondly, even if \( t^S_F > 0 \), is level is inconsequential. To see this, observe that if \( t^S_F < t^N_F \), the South’s entire output is sold in the North and the analysis is as if \( t^S_F \) was zero. If \( t^S_F > t^N_F \), the South’s output is sold in priority on the Southern market. But if some of it is also exported to the Northern market (which is, of course, necessary for RoOs to have any effect at all) then the South’s output being larger than its consumption, the Southern price is ‘competed down’ to the level of the Northern tariff-ridden price, and the analysis proceeds as before.
the transition phase, however, both are determined simultaneously. As a further simplification, whereas intrabloc tariffs are phased out progressively in a continuous manner, we assume that the phase-out is done in two steps: from MFN tariff to 'the' preferential rate (on which our analysis focuses), and hence to zero.

The politics is described by a Grossman–Helpman game in which the intermediate producers lobby faces the government with a contribution schedule $C(\delta, r)$ conditioned on the policy variables of interest to it, $\delta$ and $r$. The function $C$ has the ‘truthfulness’ property that

$$
\frac{\partial C}{\partial r} = \frac{\partial \pi}{\partial r}|_{r, \delta^*} \quad \text{and} \quad \frac{\partial C}{\partial \delta} = \frac{\partial \pi}{\partial \delta}|_{r, \delta^*},
$$

where the superscript $e$ designates equilibrium values. With only one lobby, the common agency degenerates into a simple principal-agent relationship. Without hidden action, the principal (the lobby) is then able to appropriate the entire protection rents, and any equilibrium will have the property that the government is just indifferent between implementing the lobby’s preferred policy and the default one (free trade). Put differently, the lobby’s contribution just compensates the government for the (subjective) monetary equivalent of the efficiency loss generated by trade protection. The government determines $\delta$ and $r$ to maximize a linear combination of welfare (valued at a constant monetary equivalent $a$) and the lobby’s contribution:

$$
G^N \equiv C(\delta, r) + aW(\delta, r).
$$

The pair $(\delta, r)$ is set to leave the FTA’s Southern partner on its ‘participation constraint’. Given that the South’s consumption of the final good is

---

7 The model ignores lobbying by Northern final-good producers, if any. There are several reasons for this. First, in terms of modelling issues, competitive final-good producers would be concerned about prices only, not market shares. As the Northern MFN tariff on the final good is unchanged, their profits would be unchanged as long as the area is not self-sufficient at the Northern tariff-ridden price. Secondly, even if the market is not competitive, as long as the South is on its participation constraint (more on this below) Southern exports to the North are unchanged.

Empirically, as far as NAFTA is concerned, a substantial proportion of the companies doing assembly work in Mexico for re-export into the US are either subsidiaries of US companies or non-competing subcontractors. Cases in which Mexican companies compete head on with US assemblers (either independent or vertically integrated) are, arguably, sufficiently marginal to assume that reducing such competition was not a key consideration for US negotiators.

8 This assumption about rent sharing is in conformity with the empirical observation that small contributions seem to buy ‘large’ policies in terms of redistributive effects (Ansolobehere et al., 2002). Any alternative assumption would imply larger contributions, which would go against the evidence.
always priced at $p_F^*$, consumer surplus is unaffected by changes in either $\tau$ or $r$. Thus, the only change in Southern welfare—or any political objective function combining welfare and producer surplus—is in assemblers’ profits, and the South’s participation constraint is completely characterized by $p = p^*$.

5.2.4 Equilibrium

RoOs have the effect of segmenting the intermediate good’s market in the trading bloc. Southern assemblers selling on the Northern market must comply with the RoO if they are to benefit from the preferential regime. The market on which they buy the intermediate good is then a closed-economy market where Northern supply must match the RoO-induced Southern demand. We now determine $p_I$, the price prevailing on that market.

Price determination As already noted, with their home market unprotected, Southern assemblers sell all their output on the protected Northern market where they enjoy preferential access. Suppose that $p_I$ is greater than $p_F^*$. In an interior solution, it has to be. The RoO’s domestic content is then binding, which means that a proportion $r$ of the South’s intermediate-good demand will be sourced ‘locally’ (in the North). The market-clearing condition determining the intermediate good’s domestic price is thus that the local demand induced by the RoO, $ra_Fy_I(p)$, be equal to its supply, i.e.

$$ra_Fy_I(p) = y_I(p_I),$$

where, as before, $y_F$ is the South’s final-good production and $y_I$ is the North’s intermediate-good production.

Let $p_I$ satisfy eqn (5.7). If $p_I \leq p_F^* + t^*_I$, the RoO is not binding, which means that the North’s supply of the intermediate good is sufficient to satisfy the South’s needs and more. We will henceforth disregard this case and suppose that the intermediate good’s price determined by eqn (5.7) is larger than its tariff-ridden price in the North.

Using eqns (5.3) and (5.6), the South’s participation constraint can be written as

$$p_F - a_IF[\alpha p_I + (1 - \alpha)p_F^*] = p_F^* - a_IF,$$

or, using eqn (5.5) and simplifying,

$$\delta = ra_IF\Delta p_I,$$
where $\Delta p_I = p_I - p_I^*$. Expression (5.8) says that the degree of effective protection given to Southern assemblers by the combination of $r$ and $\delta$ is zero.

In conformity with the agency literature, we will assume that when just indifferent, Southern assemblers choose to use the preferential regime. Moreover, we assume homogeneity of firms, so all of them use the preferential regime. With compliance-cost heterogeneity among Southern assemblers, the preferential regime’s utilization rate would be less than one and a decreasing function of the rate of effective protection conferred by the mix of preferences and RoOs, as in Carrere and de Melo (Chapter 7). As this would add substantial complication to the analysis, we leave it for further research.

Under compliance-cost homogeneity, the Northern government’s maximization problem under the South’s participation constraint and the intermediate-good market-clearing condition is

$$\max_{\delta, r} C_I(\delta, r) + aW^N(\delta, r)$$

s.t.

$$\delta = ra_{lf} \Delta p_I$$

$$ra_{lf} y_F(p) = y_I(p_I)$$

$$0 \leq r \leq 1, 0 \leq \delta \leq t_f^N.$$  

(5.9)

As an intermediate step before solving problem (5.9), we now calculate two useful derivatives treating $r$ as pre-determined: $dp_I/dr$ and $d\delta/dr$. The first measures the marginal effect of the RoO, expressed as a regional value content (RVC) $r$, on the intermediate good’s internal price. The second measures the substitutability between the RoO’s RVC rate $r$ and the tariff preference rate $\delta$ along the South’s participation constraint. Both apply only to interior solutions, i.e. when the inequality constraints (5.9) are not binding.

Differentiating totally eqns (5.7) and (5.8) with respect to $p_I$, $\delta$ and $r$ and rearranging gives

$$d\delta = a_{lf} \Delta p_I dr + ra_{lf} dp_I$$

$$a_{lf} y_F dr = y'_{I}dp_I.$$  

The second line gives directly

$$\frac{dp_I}{dr} = \frac{a_{lf} y_F}{y'_{I}} = \frac{p_I}{r_{e_I}} > 0, \quad (5.10)$$

where $e_I$ is the intermediate good’s supply elasticity—treated as constant—and the second part of the equation comes from eqn (5.7). As can be read
directly from eqn (5.10), the elasticity of the intermediate good’s internal price to the RoO’s RVC rate is just the inverse of its supply elasticity. As the latter goes to infinity, as expected the price becomes totally insensitive to a tightening of the RoO.

Moreover, eqn (5.10) shows that, as long as tariff preferences can be adjusted, the ambiguity of the RoO’s effect on the intermediate-good’s price noted by Ju and Krishna (1998, 2000) does not apply except at corners. The reason is that, by construction, along the South’s participation constraint value added in the final-good sector cannot go down, so (given the Leontieff technology) nor can output. In other words, here RoOs cannot become so stiff as to become self-defeating because any tightening of \( r \) is met by an offsetting increase in \( \delta \). In order to see what happens at corners, solve eqn (5.8) for \( r \) at \( \delta = t_F^N \) and define \( \tau = t_F^N/a_{IF}\Delta p_I \) as the RVC that just satisfies the participation constraint at full preferences. Ju and Krishna’s argument applies in the semi-open interval \((\tau, 1]\) if \( \tau < 1 \). With homogenous firms in the South (in terms of their compliance costs), beyond \( \tau \) the participation constraint is violated and the preferential regime’s utilization rate jumps down to zero.

Upon rearrangement, the first line of eqn (5.10) gives

\[
\frac{d\delta}{dr} = a_{IF}\Delta p_I + r a_{IF} \frac{dp_I}{dr}
\]

\[
= a_{IF}(\Delta p_I + \frac{p_I}{\delta_I}) > 0. \tag{5.11}
\]

Thus, the compensation required by a tightening of the RoO’s RVC rate, in terms of tariff preferences, has two components. The first is just the difference between the internal and world prices of the intermediate good multiplied by the input-output coefficient. The second reflects the fact that as the RoO’s RVC rate is tightened, costs go up for Southern assemblers not just because they must source a higher proportion of intermediate goods in the area where they are more expensive, but in addition, doing so puts upward pressure on their internal price. This last effect is inversely proportional to its supply elasticity.

We are now in a position to solve problem (5.9). Combining the inequality constraint on \( \delta \) with the participation constraint gives

\[
ra_{IF}\Delta p_I \leq t_F^N. \tag{5.12}
\]

Letting \( \lambda \) and \( \mu \) be two Lagrange multipliers, we have

\[
E = G[\delta(r), r] + \lambda(1 - r) + \mu(t_F^N - ra_{IF}\Delta p_I),
\]

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and the Kuhn–Tucker conditions are
\[ \frac{dG}{dr} \leq 0, r \geq 0, r \frac{dG}{dr} = 0; \]
\[ 1 - r \geq 0, \lambda \geq 0, \lambda(1 - r) = 0; \]
\[ t_N^N - ra_l \Delta p_l \geq 0, \mu \geq 0, \mu(t_N^N - ra_l \Delta p_l) = 0. \]

We now construct the expression for \( dG/dr \) that will be set equal to zero under the first-order condition. It has two components: a contribution effect and a welfare effect.

**Contribution effect** Using Hotelling’s lemma and the contribution function’s truthfulness property, we have, in the neighborhood of the equilibrium,
\[ \frac{dC}{dr} = \frac{d\pi_l}{dr} = y_1 \frac{dp_l}{dr} = \begin{cases} p_1 y_1 / r & \text{if } r < \bar{r} \\ 0 & \text{if } r > \bar{r}, \end{cases} \] (5.12)
and the derivative is undefined at \( r = \bar{r} \) because \( p_l \) jumps down to one at that point (because the preferential regime’s utilization rate falls to zero). Thus, left to itself—i.e. absent any welfare consideration—the Northern intermediate-good lobby would be willing to push RoOs to \( \bar{r} \), the level of RoO strictness that makes Southern assemblers just indifferent between using the preferential regime or not given tariff-free access (\( \delta = t_N^N \)).

Combining eqns (5.12) and (5.11), it is apparent that the Northern intermediate-good lobby is willing to contribute in favor of ‘deep’ tariff preference in the downstream sector because, along the South’s participation constraint, tariff preference buys stiffer RoOs, which in turn are to its advantage.

**Welfare effect** Let \( m_F \) and \( m_F^* \) be the North’s imports of final goods from the South and from the rest of the world, respectively. As the North does not produce the final good, \( m_F + m_F^* = c_F \). Under quasi-linear preferences, Northern welfare is the sum of income—from profits, wages and tariff revenue—and consumer surplus, which by eqn (5.1) comes only from consumption of the final good. Formally,
\[ W^N = \pi_l + w^N \ell_1 + \tau m_F + t_F^N m_F^* + u(c_F) - p_F c_F. \]

As \( m_F = y_F \) (the South exports its entire final-good output to the North), \( m_F^* = c_F - m_F = c_F - y_F \), so
\[ W^N = \pi_l + w^N \ell_1 + t_F^N c_F - \delta y_F + u(c_F) - p_F c_F. \] (5.13)

* We are grateful to Maurice Schiff for helping to clarify this discussion.
Along the South’s participation constraint, $p$ is constant and hence so is $y_F$. Thus, treating $p_I$ and $d$ as endogenous variables along the problem’s constraints,

$$\frac{dW^N}{dr} = y_I \frac{dp_I}{dr} - y_F \frac{d\delta}{dr} = \frac{p_I y_I}{r \epsilon_I} - a_{\epsilon_I} y_F \Delta p_I + \frac{p_I}{\epsilon_I}.$$  

Using the fact that, by eqn (5.7), $a_{\epsilon_I} y_F = y_I / r$, this becomes

$$\frac{dW^N}{dr} = y_I \left\{ \frac{p_I}{r \epsilon_I} - (\Delta p_I + \frac{p_I}{\epsilon_I}) \right\} = -\frac{y_I}{r} \Delta p_I < 0. \tag{5.14}$$

Combining the contribution and welfare effects gives

$$\frac{dG^N}{dr} = \frac{dC}{dr} + a \frac{dW^N}{dr} = \frac{p_I y_I}{r \epsilon_I} - a \frac{y_I}{r} \Delta p_I = \frac{p_I y_I}{r} \left( \frac{1}{\epsilon_I} - a \frac{\Delta p_I}{p_I} \right).$$

Under the first-order condition, this expression is set equal to zero, so

$$\frac{p_I}{\Delta p_I} = a \epsilon_I. \tag{5.15}$$

The second-order condition requires $a \epsilon_I > 1$, which we assume to hold.$^{10}$

It can be shown by algebraic manipulation that, along the first-order condition, $r$ is a decreasing function of $\delta$. However, the equilibrium value of $r$ that is observed in the data is not determined just by the model’s first-order condition but by its intersection with the participation constraint along which $r$ is an increasing function of $\delta$. Using eqn (5.8) to substitute for $\Delta p_I$ in eqn (5.15) gives

$$r = \frac{\delta a \epsilon_I}{a_{\epsilon_I} p_I}. \tag{5.16}$$

$^{10}$ This assumption is not innocuous. The parameter $a$ is, in our setting, the dollar amount that the intermediate-good lobby must contribute per equivalent-dollar of welfare reduction. As contributions are typically small relative to the distortionary costs of trade policies, $a$ is likely to be less than one. Then $\epsilon_I$, the elasticity of supply of intermediate goods, must be above one. When this assumption is violated, a corner solution occurs at either $r = 0$ (no RoO) or $r = \tau$. 

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Reintroducing the inequality constraints, the solution is thus

\[
 r = \begin{cases} 
 t_N^N/a_{iF}p_i & \text{if } \delta a_{iF}/a_{iF}p_i \geq t_N^N \\
 0 & \text{if } \delta a_{iF}/a_{iF}p_i \leq 0 \\
 \delta a_{iF}/a_{iF}p_i & \text{otherwise.} 
\end{cases}
\]

With several inputs indexed by \(i\) and one output indexed by \(j\), it is easily verified that eqn (5.16) becomes

\[
 r_j = \frac{a_j}{\sum_i a_{ij}p_i/a_i}. 
\]

This expression will guide the empirical analysis in the section that follows.

5.3 Market access and RoO determination

5.3.1 The data

The estimation is carried out on a panel dataset covering the period from 1994 to 2001 and containing information on commodity trade and tariffs between Mexico to United States under MFN and preferential regimes. The data was compiled mostly from USITC sources at the 6-digit HS level of disaggregation. The data on Rules of Origin comes from Estevadeordal (2000). Descriptive statistics are shown in Table 5.1.

5.3.2 Empirical estimation

We estimate two equations: a market-access one and a political one. Let \(j\) stand for a tariff line (at the HS6 level) and \(t\) for time measured in years. The estimated system has a peculiar structure in the time dimension.

| Table 5.1 Descriptive statistics |
|-------------------------------|-------|----------|
| Variable                      | Obs   | Mean     | Std. Dev. |
| log RoO restrict. index       | 41 944| 1.5753   | 0.3380    |
| log pref. margin              | 41 834| 0.0255   | 0.0500    |
| log Mex. NAFTA exp.          | 21 041| 13.093   | 3.090     |
| log Mex.exports to ROW       | 33 706| 11.819   | 2.959     |
| agriculture                  | 41 944| 0.1024   | 0.3032    |
| final                        | 41 944| 0.2530   | 0.4347    |
| Chge of Chap.                | 41 944| 0.5208   | 0.4996    |
| Chge of Heading              | 41 944| 0.3863   | 0.4869    |
| Dhge of Sub-head             | 41 944| 0.0411   | 0.1986    |
| Exception                    | 41 944| 0.4439   | 0.4968    |
| Technical req.               | 39 873| 0.0651   | 0.2466    |
| Regional value content       | 41 723| 0.2713   | 0.445     |
Mexican exports to the US \((y_{jt})\) and to the world \((x_{jt})\) vary over time. So does the rate of preference \((\delta_{jt})\), as NAFTA’s tariff reductions were phased in progressively over a transition period (on this, see Estevadeordal, 2000). By contrast, Rules of Origin \((r_j)\) were negotiated once and for all in the early 1990s. Thus, the market-access equation must be estimated on panel data, whereas the political determination of RoOs must be estimated on a cross-section of tariff lines with the variables suggested by the model as likely determinants of RoOs, as of the 1990s.

We measure RoOs in two alternative ways. First, we use a vector of binary variables, each marking the presence of a specific RoO instrument (change of tariff heading, technical requirement, etc.). Secondly, we use Estevadeordal’s synthetic index. Using both proxies provides a check on the construction of Estevadeordal’s index, as estimated coefficients should be larger in absolute value for instruments assigned a higher value in his index.

Thus, the market-access equations to be estimated is either

\[
\ln y_{jt} = x_{0t} + x_1 \ln x_{jt} + x_2 \ln \delta_{jt} + x_3 r_j + u_{jt},
\]

where \(x_{jt}\) stands for Mexican exports of good \(j\) to the rest of the world, \(\delta_{jt}\) is the rate of preference granted to good \(j\) in year \(t\) under NAFTA, \(r_j\) is Estevadeordal’s (2000) index of RoO strictness, and \(u_{jt}\) is an error term. Alternatively,

\[
\ln y_{jt} = x_{0t} + x_1 \ln x_{jt} + x_2 \ln \delta_{jt} + \sum_{k=1}^{n} x_k r_{kj} + u_{jt},
\]

with a vector of \(n\) binary variables for the \(n\) legal forms of RoOs.

We control for serial correlation in the time dimension by time effects and for unobserved industry characteristics by fixed effects at the section level. As the estimation is carried out at the hs6 level of aggregation, we control for heteroskedasticity by using weighted least squares, the weight being Mexico’s total exports. Expected signs and magnitudes in eqn (5.18) are \(x_1 > 1, x_2 > 0, x_3 < 0\), and, in eqn (5.19), \(x_{k+1} < x_{k} < 0\) if RoO type \(k + 1\) is assigned a higher value than RoO type \(k\) in Estevadeordal’s index.\(^{11}\)

---

\(^{11}\) This equation can be justified as follows. Consider a Mexican final-good exporter maximizing profits by choice of a mixture of export destinations. Let \(y\) stand for the value added of exports to the US, \(x\) for the value added of exports to the rest of the world, and let \(p\) be the relative net price in the US. Assume that the firm produces out of a fixed pool of resources \(R\) under a Constant Elasticity of Transformation technology (Powell and Gruen, 1962), i.e. \(x^\alpha + y^\alpha = R\), where \(x\) is the inverse of the elasticity of transformation. The value of \(R\) is itself determined in the previous stage of a two-stage optimization problem. The second-stage problem is thus

\[
\max_{x,y} x + py \text{ s.t. } x^\alpha + y^\alpha = R.
\]
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The political equation is based on eqn (5.17) in log form. As values of $\delta$ during the phase-out period were determined simultaneously with Rules of Origin, we instrument for $d$ using its steady-state value $d_j$, the US MFN tariff (the value for 2001), and other variables $s_j$ dummies signalling an agricultural good or a consumption good rather than intermediate good.\(^\text{12}\) Thus,

$$
\ln r_j = \beta_0 + \beta_1 \ln \left( \sum_i a_{ij} p_i / e_i \right) + \beta_2 \ln \delta_j + \beta_3 s_j
$$

(5.20)

Alternatively, noting that, by eqn (5.10)

$$
\frac{p_i}{e_i} = \frac{r \delta_j y_j}{y_i} = \frac{y_j}{y_i},
$$

it follows that

$$
\sum_i a_{ij} \frac{p_i}{e_i} = \sum_i a_{ij} \frac{y_j}{y_i},
$$

so letting $z_j = \sum_i a_{ij} y_j / y_i$, the equation to be estimated becomes

$$
\ln r_j = \beta_0 + \beta_1 \ln z_j + \beta_2 \ln \delta_j + v_j,
$$

(5.21)

where $\beta_0 = \ln a < 0$ (if $a < 1$), $\beta_1 < 0$, $\beta_2 = 1$, $v_j$ is an error term, and $z_j = \sum_i a_{ij} y_j / y_i$ is proxied (with measurement errors since $y_i$ is unobserved) by $\sum_i a_{ij} y_i$, the sum, over all goods $i$ upstream of $j$, of the product of US exports of good $i$ to Mexico, $y_i$, times the share $a_{ij}$ of good $i$ in good $j$’s output.

Note that there is no endogeneity bias from the fact that $z_j$ is a linear combination of intermediate-good exports from the US to Mexico that

The FOC yield $y/x = p^{1/(x-1)}$ or

$$
\ln y = \frac{1}{x-1} \ln p + \ln x,
$$

a functional form close to eqn (5.18). If this equation is roughly invariant across tariff lines, the elasticity of transformation between the US and the ROW can be retrieved from the parameter estimate on the tariff-preference term, whereas the parameter estimate on exports to the ROW should be insignificantly different from one.

The interest of this formulation is that because of the curvature of the transformation surface, the export mixture is an interior solution even when the participation constraint is binding (i.e. when $p = 1$), an observation that is largely true at the tariff line (although not necessarily true at the firm level). This framework can be easily extended to a three-dimensional choice in which exports to the US can be made under either the preferential regime or the MFN one. If the choice between legal regimes for exports to the US involves no efficiency consideration, the transformation surface can be represented as

$$
x^x + (y_{NAFTA} + y_{MFN})^y = R.
$$

\(^\text{12}\) We also tested an alternative formulation, namely $\delta_j = \sum_{t \in \delta} \beta^t \delta_t$ with $\beta = 0.9$. The results were similar.
may be affected by final-good exports from Mexico to the US because \( z_i \) is calculated as an average for three years before NAFTA’s entry into force, so the link between the two types of trade flows is tenuous at best. Thus, the system is recursive and estimated as such.

As Estevadeordal’s RoO index is a categorical variable that takes on integer values between one and seven, the political equation is estimated as an ordered probit. As a result, direct quantitative interpretation of parameter estimates in terms of eqn (5.21) is not possible. As the model assumes that RoOs take the form of a continuous RVC, whereas actual ones are combinations of discrete instruments, there is no way around this difficulty.

5.3.3 Results

Estimation results are shown in Tables 5.2 and 5.3.

Column (1) of Table 5.2a shows results for eqn (5.21). The dependent variable is the log of Estevadeordal’s index. The regressor called ‘upstream’ is \( z_i \) averaged out over 1989–93. Its coefficient is negative as predicted and significant at the one per cent level. The coefficient on the log of the US MFN tariff is positive as predicted, and also significant at the one per cent level. The coefficients are robust to other specifications where additional

<table>
<thead>
<tr>
<th>Table 5.2a Regression results, RoO equation</th>
</tr>
</thead>
<tbody>
<tr>
<td>dep. var (log) Procedure</td>
</tr>
<tr>
<td>Procedure</td>
</tr>
<tr>
<td>upstream</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Mex. MFN tariff 93</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Agriculture</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Final</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Constant</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Observations</td>
</tr>
<tr>
<td>R-squared</td>
</tr>
</tbody>
</table>

Notes:
All regressions with section, year dummy and weighted by total Mex.exports. standard-errors in parenthesis.
* significant at 5% level, ** significant at 1% level.
(1) and (2): ordered probit. pseudo R2
(3): ordered probit; heterogeneity by HS section.
Variables are thrown in. In column (2), the coefficient of the log of initial Mexican MFN tariff is negative and significant, which supports the view that Rules of Origin are meant to avoid the trade-deflection effect. The easier it is to enter into the Mexican market, the higher the rule of origin. As expected, a final good is associated with a more restrictive rule of origin.\(^\text{13}\) The relatively low explanatory power of the regression is not a surprise given that it is very parsimonious, that the data is only a cross-section, and that the dependent variable is itself a constructed one.

Column (3) takes into account heterogeneity in the coefficient of the RoO index. Allowing for heterogeneity (at the section level in the HS classification), the sign of the US MFN tariff becomes negative, but the coefficient of the ‘upstream’ variable that stems from the political-economy model seems quite robust.

Columns (4) and (5) of Table 5.2b show an ad hoc regression of tariff preferences on the log of the 2001 value of the US MFN tariff (equal to the steady-state value of NAFTA tariff preferences), the log of the Mexican MFN tariff, and the predicted value of the RoO index from eqn (5.21):

\[
\ln (1 + \delta_j) = \gamma_0 + \gamma_1 \ln (1 + \delta_j) + \gamma_2 \ln (1 + \theta_{0j}^{\text{Mex}}) + \gamma_3 \hat{r}_j + \nu_j. \tag{5.22}
\]

\(^\text{13}\) We used the BEC’s classification rather than the WTO’s because the latter classifies all goods in automobile and machinery and equipment as final ones, whereas vertical trade in those sectors is particularly important for Mexico.
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Table 5.3a Regression results, market-access equation

<table>
<thead>
<tr>
<th>Dep. Var.: log Mex. pref. exports</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports to ROW</td>
<td>0.611</td>
<td>0.577</td>
<td>0.5761</td>
</tr>
<tr>
<td></td>
<td>[0.006]**</td>
<td>[0.006]**</td>
<td>[0.006]**</td>
</tr>
<tr>
<td>RoO restrict.</td>
<td>−0.395</td>
<td>1.887</td>
<td></td>
</tr>
<tr>
<td></td>
<td>[0.031]**</td>
<td>[0.193]**</td>
<td></td>
</tr>
<tr>
<td>Pref. margin</td>
<td>2.828</td>
<td>0.199</td>
<td></td>
</tr>
<tr>
<td></td>
<td>[0.006]**</td>
<td>[0.006]**</td>
<td></td>
</tr>
<tr>
<td>Chge of Chap.</td>
<td>−1.095</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>[0.131]**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chge of Head.</td>
<td>−0.751</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>[0.115]**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chge of Sub-head.</td>
<td>−0.773</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>[0.112]**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exception</td>
<td>0.506</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>[0.036]**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reg. Value Content</td>
<td>−0.432</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>[0.032]**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tech. req.</td>
<td>1.000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>[0.055]**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Upstream</td>
<td></td>
<td></td>
<td>0.226</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>[0.012]**</td>
</tr>
<tr>
<td>US MFN tariff 2001</td>
<td>3.128</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>[0.189]**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mex MFN tariff 93</td>
<td>2.696</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>[0.305]**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pref.margin=0</td>
<td>−0.147</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>[0.268]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>US MFN=0</td>
<td>0.722</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>[0.280]**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>7.094</td>
<td>7.925</td>
<td>3.748</td>
</tr>
<tr>
<td></td>
<td>[0.573]**</td>
<td>[0.555]**</td>
<td>[0.377]**</td>
</tr>
<tr>
<td>Observations</td>
<td>19 951</td>
<td>19 032</td>
<td>19 343</td>
</tr>
<tr>
<td></td>
<td>0.70</td>
<td>0.72</td>
<td>0.71</td>
</tr>
</tbody>
</table>

Notes:
Dependent variable: log of Mexican exports under Nafta regime
All regressions are weighted. Standard-errors in parentheses. * significant at 5% level;
** significant at 1% level.

Tariff preferences are influenced by the US MFN tariff and, to a lesser extent, by the initial Mexican tariff. Although \( \delta \) and \( r \) are negatively related along the model’s FOC condition, the negative coefficient of the RoO index’s predicted value has no direct interpretation as observed pairs \((r, \delta)\) are determined jointly by the FOC and the participation constraint. The last two columns—(6) and (7)—of Table 5.2b show the results of seemingly unrelated regressions, where the RoO restrictiveness index and the preferential margin are assumed to depend on the same variables. Independence between the two equations is rejected though the residuals correlation is low.
Table 5.3 shows estimation results for the market-access equations (5.18 and 5.19).

Columns (1)–(3) of Table 5.3a report estimation results of Mexican exports ignoring the endogeneity issue. Column (1) shows the results of eqn (5.18). The coefficient on the log of Mexican exports to the ROW is 0.61 (and is quite stable across equations). The coefficient of the preference margin is positive, as expected, and significant at the one per cent level. The sign of the coefficient of RoO restrictiveness is negative, as expected. The explanatory power of the regression is quite high (with an unadjusted R-square of 0.7). In column (2), Estevadeordal’s synthetic index is replaced by a vector of binary variables that code if the RoO...
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requires a change at different levels of tariff classification or a technical specification, a regional value content and if it allows any exception to the rule. The coefficients on RoO instruments are all significant at the one per cent level. Concerning the changes in tariff classification, their ranking is consistent with Estevadeordal’s index: the more demanding the change in classification, the more negative is the impact of preferential imports. The coefficient of regional value content is also negative. However, the coefficient of dummies associated with the requirement of a technical specification or the existence of an exception are positive. Perhaps, this might be explained by the fact that a technical requirement is always associated with a change in classification. Column (3) runs the same regression, where both the RoO index and the preferential margin are replaced by explicative variables used in Table 5.2. All coefficients are positive, including the upstream variable. The only exception is a dummy that records if the preferential margin for that good is equal to 0. In that case, as can be expected, exporting under Nafta is of no interest.

Columns (4) and (5) of Table 5.3b take into account the endogeneity problem by using instrumental variables for both the RoO index and the preferential margin. As a result, the order of magnitude of the coefficient of the RoO index increases to a level comparable to the coefficient of preferential margin. Column (6) tests for the evidence of a learning curve, by interacting the coefficient on RoO with year effects. The order of magnitude of the coefficients of the interaction terms is indeed decreasing over time and is not significant after 1999. A test of equality of coefficients shows that the coefficients are significantly different only in 1997 compared to 1996 (and again in 2000 compared to 1999). The learning curve is thus not as marked as for Central and Eastern European countries (Tumurchudur, 2004).

Columns (7) and (8) of Table 5.3b show estimation results where the preferential margins and the RoO index are replaced by their predicted values from the sequential eqns (5.21) and (5.22) reported in Table 5.2. Finally, column (9) reports the estimation results of Mexican exports on preferential margin and RoO index predicted in the seemingly unrelated regressions. Signs and levels of significance are unaffected, suggesting that qualitative conclusions hold irrespective of the handling of endogeneity issues. However, the magnitudes of point estimates are seriously affected, especially if one takes into account a possible heterogeneity of the impact of RoO across sectors, suggesting that quantitative conclusions must be drawn carefully.
Two messages come out of our results. One is empirical, the other conceptual. First, at the empirical level, NAFTA’s Rules of Origin seem to dilute the benefits generated by preferential trade liberalization, in terms of market access, for Mexico. This result, which is in conformity with the findings of the recent literature, suggests that RoOs should indeed be viewed as an economically sensitive item rather than a technical one in the agenda of bilateral trade negotiations. Moreover, the effect seems to be stronger for final goods than for intermediate ones, in conformity with what one would expect in a multistage production model where each stage is located according to the production stage’s factor intensity and the host-country factor abundance. This result begs the question, why do Northern partners create policy instruments that put hurdles in a process that is economically efficient? One reason might be that RoOs are the price to pay for the acquiescence of Northern final-good producers threatened by Southern competition. However, many of the final-good assemblage activities undertaken by Southern ‘maquiladoras’ are non-competing, making this explanation less than satisfactory.

The second point of our chapter is about this issue. We use a standard model of endogenous trade policy—Grossman and Helpman’s common-agency model—to explore an alternative logic, namely that RoOs reflect political pressure by Northern intermediate-good producers interested in creating captive markets for their goods in the South. The logic is as follows. On the assumption that the Mexican side is on its ‘participation constraint’, i.e. that the rate of effective protection conferred to Mexican final-good producers by the simultaneous use of tariff preferences and RoOs is just about zero, tariff preferences are the price to be paid for Mexican assemblers’ acquiescence to a system that forces them to buy US intermediate goods. Seen in this way, as the model shows, preferences-cum-RoOs amount to a pure transfer from US taxpayers to intermediate-good producers, i.e. to a hidden export subsidy. Because export subsidies are in violation of any country’s obligations under the GATT, recourse to an indirect and inefficient substitute instrument—RoOs—makes sense.

Empirically, the model suggests the inclusion, among the right-hand side variables of the second equation (RoO determination), of the product of input-output coefficients by US intermediate sales to Mexico. This somewhat unintuitive prediction provides a test of the approach’s validity, since it is difficult to think of an alternative theoretical approach that would lead to the inclusion of that particular algebraic term. Empirical results are in
striking conformity with the model’s predictions. In sum, they suggest that the use of NAFTA to create a captive market for US intermediates was indeed one of the forces shaping the agreement’s Rules of Origin.

References

Rules of Origin as export subsidies


Legal Frameworks for North-South RTAs under the WTO System

Submitted by: APEC Study Center, JETRO
Legal Frameworks for North-South RTAs under the WTO System

Akiko Yanai
APEC Study Center
Institute of Developing Economies, JETRO

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I. Introduction

Since the 1990s, there has been a global trend toward bilateral and regional trade arrangements. The number of such arrangements that have been formed, or are currently being negotiated, has dramatically increased, and consequently, at present almost all countries are party to such arrangements. One of the characteristics of recent regional trade agreements (RTAs) are their comprehensiveness. Not only do they cover the reduction or elimination of tariffs and other non-tariff barriers on the trade of goods and services, but they also cover broader elements such as investment rules, intellectual property rights and so on.

Besides this comprehensiveness, a noteworthy feature of recent RTAs is that those formed between developed and developing countries (hereafter referred to as North-South RTAs) are on the increase in terms of both number and impact. In the Asian region in particular, North-South RTAs have become a hot issue owing to changes in Japan’s trade policy. From the late 1990s, Japan actively began to promote RTAs in order to strengthen cooperative relationships between itself and other countries in the region. RTAs including Japan and other Asian countries inevitably fall into the category of North-South RTAs. In negotiations with Japan, Asia’s developing countries seem to show an attitude that they do not necessarily oblige equal liberalization to Japan.

Under the current legal system of the World Trade Organization (WTO), there are two categories of rules on RTAs in the area of trade in goods: the first is based on Article XXIV of the General Agreement on Tariffs and Trade (General Agreement), which generally applies to all RTAs; the second is based on the so-called Enabling Clause, which, in exceptional circumstances, provides special and differential treatment (SDT) for RTAs among developing countries. Although both categories allow for deviations from the WTO guiding principle of non-discrimination, the necessary conditions of RTAs negotiated under the rules differ considerably. The criteria stipulated in Article XXIV are much stricter than the ones of the Enabling Clause. This dualistic legal framework means that developing countries tend to believe that they can be exempt from equal liberalization when they negotiate bilateral or regional RTAs with developed countries.

The kind of rules that govern North-South RTAs influences the kind of contents and levels of liberalization to which the parties of such RTAs agree. In order to clarify the applicable rules on North-South RTAs, this paper considers why rules on RTAs and the concept of SDT were incorporated into the GATT/WTO legal framework so as to permit the derogation of most-favored-nation (MFN) obligations (Parts I and II respectively). This paper also looks at existing practices of North-South RTAs (Part III) and the way in which North-South RTAs are made compatible with WTO rules (Part IV).
II. Applicable Rules on RTAs

The General Agreement on Tariffs and Trade (GATT)\(^1\) system was established in order to prevent the discriminatory trade practices contributed to the development of economic blocs before World War II. The GATT, therefore, adopted non-discrimination as a fundamental principle. An unconditional MFN clause was incorporated into Article I of the General Agreement, as this was conceived as the most effective measure for applying the non-discrimination principle to actual trade practices. Thus, the GATT strictly confined preferences to the practices that existed when it was established,\(^2\) meaning that it would not in principle permit the creation of any new preferences. However, there is no principle without exceptions, and RTAs are formally recognized as exceptions to MFN obligations under the GATT/WTO system.

II-1. Background: Approving RTAs as Exceptions to MFN Treatment

In Article XXIV of the General Agreement, exceptions to MFN treatment are provided in three situations: traffic frontiers, Customs Unions (CUs), or free trade areas. It is the latter two arrangements which are usually referred to as RTAs. Even an interim agreement leading to the formation of a CU or a free trade area is included in this provision. As to frontier traffic and CUs, they have been recognized as exemptions to MFN obligations in many bilateral commercial agreements for more than two hundred years. At the drafting process of the General Agreement, therefore, the inclusion of these exceptions in the agreement was uncontroversial.

Besides frontier traffic and CUs, the GATT broadly permits the formation of free trade areas as an exception to MFN treatment. Why did the GATT let a provision for free trade areas come into the agreement? The first Draft Charter for the International Trade Organization (ITO), which was put forward by the US government in 1946, recognized only CUs as exceptions to the MFN rule.\(^3\) It was at the drafting conference that the original concept of free trade areas appeared (GATT 1970: 798). In 1947, developing countries proposed the initial concept of free trade areas where “two or more developing countries might be prepared to abolish all trade barriers among themselves, though

---

\(^1\) Though the GATT was not originally an institution established under a treaty-based instrument like the United Nations, but merely a general agreement, it has had an actual secretariat and has functioned as a de facto international institution. In order to distinguish these two aspects of the term, in this paper, the term “GATT” will mean institution and the term “General Agreement” will mean international agreement.

\(^2\) Article I simply allows preferential trading arrangements in force at the time of GATT’s establishment to last as exceptions to the MFN principle with the conditions listed in the Annex. Almost all are imperial preferences or preferences between neighboring states.

\(^3\) In March 1948, the ITO Charter was adopted at the United Nations Conference on Trade and Employment in Havana. Since only two countries ratified the Charter, the plan to establish the ITO lost momentum. However, in order to enforce the results of the round, parts of the ITO Charter were selected to form the core of the General Agreement.
not wishing to construct a common tariff towards the rest of the world” (Haight 1972: 393). Developing countries might have thought that non-discrimination principles did not always benefit them and a certain degree of preferential treatment would be necessary in order to promote their economic development. Moreover, they needed schemes more flexible than CUs because they regarded these as very poor measures for utilizing preferential treatment due to their strict conditions. The concept of a free trade area received support from many participants in the drafting session, especially from European countries, and it was successfully incorporated into the draft agreement.

European countries regarded this concept of free trade areas as an extension of the bilateral preferential trade arrangements that had been a common practice in Europe before World War II. It was uncertain whether the first proposal of free trade areas had reciprocity as a feature. However, it came to absorb reciprocity as a feature after the European countries took the initiative and introduced their own free trade area. The GATT included this provision because it was recognized from the outset that member countries would want to establish certain reciprocally-preferential economic relationships (Baucus 1989: 19). In addition, it was pointed out that most of the GATT contracting parties had in effect taken the position that some discrimination would help to promote trade liberalization and that not all discrimination was bad (Haight 1972: 394; Hudec 1991: 175–6).

During the ITO drafting session, the United States intended that preferences should be restrained and ultimately eliminated. Yet the US government also intended to apply the General Agreement as widely as possible in order to enhance its effectiveness. To realize this second objective, it was considered necessary to involve as many countries as possible. However, many countries attending the drafting conference placed more value on “reciprocity” than “non-discrimination.” With the purpose of convincing nations to join the GATT, the drafters had to include several measures that would allow nations to pursue their national interests and ease their fears about yielding sovereignty to an international body (Baucus 1989: 5). As a result, the United States compromised on the issue of including new preferences and accepted free trade areas as an exception to the unconditional MFN clause.

The flexibility in the MFN obligation of the General Agreement was quite necessary (Hudec 1991: 175). Free trade areas were adopted in Article XXIV so that they could function as a control valve to reconcile the internal conflict between MFN treatment and reciprocity in the fundamental GATT principles.

---

4 In order that a preferential arrangement is authorized as a CU, it should meet at least three requirements: the elimination of duties among parties, the setup of common external tariffs, and the harmonization of foreign trade regulations.
II-2. General Rules on RTAs under the WTO System

In order to allow the establishment of RTAs as an exception to the guiding principle of non-discrimination, the GATT/WTO, depending on the type of RTAs, imposes specific conditions through three sets of rules. These are: Paragraph 4 to 10 of Article XXIV of the General Agreement,\(^5\) Article V of the General Agreement on Trade in Services (GATS), and the so-called Enabling Clause. These are the only general rules regarding RTAs which have legally-binding power in the current regime of international economic law.

**Article XXIV of the General Agreement**

The provisions of Article XXIV of the General Agreement provide the basic rules on preferential arrangements covering trade in goods. A CU is defined as “the substitution of a single customs territory for two or more customs territories” between the territories of contracting parties, while a free trade area is described as “a group of two or more customs territories in which the duties and other restrictive regulations of commerce are eliminated” (General Agreement, Article XXIV: 8). In order to be identified as a CU or a free trade area, an agreement has to meet the condition, set out in the provisions of Article XXIV, that is usually phrased as “substantially all the trade.” This requires that duties and other restrictive regulations of commerce must be eliminated on “substantially all the trade” between the constituent territories of a CU or a free trade area in products originating in such territories.\(^6\)

Besides the condition, “substantially all the trade,” Article XXIV further stipulates certain criteria for the formation of RTAs.

- A “stand still” condition: the duties and other regulations of commerce should not on the whole be higher or more restrictive than the general incidence of the duties and regulations of such commerce applicable in these countries prior to the formation of a CU or free trade area.
- “A reasonable length of time” condition: any CU or free trade area should be formed within “a reasonable length of time.” This ambiguous term has lately been clarified to mean exceeding ten years only in exceptional circumstances.

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\(^5\) The original Article XXIV in the General Agreement is complemented by an additional Article XXIV in Annex I that describes notes and supplementary provisions. It is also clarified in the Understanding on the Interpretation of Article XXIV of the GATT 1994.

\(^6\) Because of its unclear language, calculating “substantially all the trade” is at the center of the argument.
• All RTAs and interim agreements must be notified to the Council for Trade in Goods (CTG) and be examined by the Committee on Regional Trade Agreements (CRTA) for their conformity to these criteria.

In addition to these criteria, a panel report in 1994 clarified several other conditions for RTAs (GATT 1994).

• Because of the use of the plural in the phrase “between the constituent territories” in Article XXIV: 8, all parties should liberalize their trade in products on a reciprocal basis.

• Article XXIV only covers RTAs “between the territories of contracting parties.” In other words, any RTA involving a non-contracting party cannot be understood as an RTA in the terms of Article XXIV and, consequently, cannot be justified as an exception to MFN obligations. In order for RTAs involving non-members to be approved, the procedure is expected to be in accordance with Article XXIV: 10.

The lack of precision and clarity of requirements generates problems in applying these rules to RTAs. The examination mechanism regarding the consistency of RTAs to WTO rules does not function properly, which exacerbates the problem. Accordingly, de facto deviation from GATT discipline and such a situation can and will be able to be observed as partial or discretionary RTAs have spread out.

Article V of the GATS
The GATS, which entered into effect in 1995 as a result of the Uruguay Round, stipulates MFN treatment as a general obligation under Article II, whereas the provisions of Article V allow member countries to enter into bilateral or regional agreements to liberalize trade in services. The basic conditions are equal to the terms of Article XXIV of the General Agreement:

• The “substantially all the trade” condition: agreements shall have substantial sectoral coverage;
• The “stand still” condition: agreements shall eliminate existing discriminatory measures and/or prohibit new or more discriminatory measures;
• Agreements shall be notified to the Council for Trade in Services (CTS).

Importantly, provisions of Article V of the GATS cover all RTAs concluded in the area of trade in services regardless of the status of its participants in the WTO. Whoever the parties to an
RTA—that is North-North, South-South or North-South RTAs—every RTA is treated equally. This is the distinctive feature of Article V of the GATS that differs from the rules of RTAs in the sphere of trade in goods.

**The Enabling Clause**

The GATT decision by the contracting parties on November 28, 1979, usually referred to as the Enabling Clause, legalized derogations from MFN obligations in favor of developing countries. With respect to RTAs, paragraph 2(c) of the Enabling Clause allows preferential trade in goods among developing countries without the need to fulfill all the conditions of article XXIV.

- The Enabling Clause covers regional or global arrangements entered into “amongst less-developed contracting parties” for the mutual reduction or elimination of tariffs and non-tariff measures “on products;”
- Trade arrangements among developing countries are designed not to raise barriers to or create undue difficulties for trade with any other contracting parties;
- Trade arrangements among developing countries shall not constitute an impediment to the reduction or elimination of tariffs and other restrictions to trade on an MFN basis;
- Trade arrangements among developing countries are to be reported to the Committee on Trade and Development (CTD). Notification and examination of the consistency of such arrangements with WTO rules are not essentially required.

The introduction of the Enabling Clause into the GATT/WTO legal framework implies approval of two different rules applicable to preferential trade arrangements in goods. Which rule applies to the relevant RTA depends on the status of participating parties. RTAs that include even one developed country as a participating party are governed by Article XXIV, whereas RTAs between developing countries fall into the Enabling Clause category. From the viewpoint of the current WTO legal system, North-South RTAs are covered by Article XXIV. However, as the number of North-South RTAs increases, and as recognition of the usefulness of such RTAs spreads among developing countries, these countries are requesting extensions to the applicable range of the Enabling Clause to North-South RTAs.

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7 The formal title of the decision is “Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries.” The decision was one of result of the Tokyo Round (1973–9).
8 The lack of definition of a “developing country” within the GATT/WTO leads to another problem of what countries can enjoy the rights granted by these provisions.
9 However, some cases were or are examined for their compatibility with WTO rules by the related committee. For example, Mercado Común del Sur (MERCOSUR) is under examination by the CRTA.
III. Normative Influences of SDT on RTAs

The provisions of Article XXIV were originally incorporated into the General Agreement at the drafting stage, as a result of a compromise between two principles, non-discrimination and reciprocity. By contrast, the Enabling Clause was added to the GATT/WTO legal framework later, as a consequence of the strong demand for preferential treatment in favor of developing countries. It should be noted that the grounds for justifying such a deviation from the MFN obligation through the Enabling Clause differ from the grounds for such a justification under Article XXIV. The Enabling Clause is based on the SDT normative guideline in favor of developing countries.

III-1. The Developmental Process of the SDT Concept

As widely recognized, the GATT adopted a non-discrimination principle as the most appropriate concept in order to establish a stable and liberalized international trade system. An unconditional MFN clause was deemed the only approach for realizing the non-discrimination principle in multilateral trade. These thoughts reflected the prevailing ideas when the General Agreement was drafted—that “MFN treatment transposes equality under international law into the economic field” (Espiell 1971: 35). The principle of sovereign equality under traditional international law was based on the assumption that each nation state had identical abilities. This assumption did not take into account de facto inequality, such as different stages of development between countries. It essentially supposed that international society consists of homogenous and consequently equal nation-states, and it considered that de facto inequality could be eliminated as long as it did not significantly prevent nation states from excising their rights (Ida 1985: 612).

In the mid-1950s, however, a new idea arose against this entrenched belief. Its proponents argued that the single legal framework based on a false assumption of equality between states should be replaced with a two-tier structure: one tier would apply to relations among developed countries, while the other would apply to relations between developed and developing countries. This idea of differential treatment was based on the argument that equal treatment could secure equality only among identical parties, but it was only unequal treatment which could correct inequalities between different parties. The resulting view was that “the operation of a MFN clause is not an adequate or expedient means of ensuring that international trade becomes an instrument of progress, especially for the benefit of the developing countries, as it is now universally agreed that it should be” (Espiell 1971: 29).

The original General Agreement did not include any SDT provisions for developing countries,
even though the ITO Charter, which was a prototypical agreement of the General Agreement, permitted, in exceptional circumstances, the exemption of developing countries from the Charter’s legal obligations on the basis of “economic development.” The developing countries were never satisfied at receiving equal treatment under the initial GATT system, and began to advocate obtaining special status. The active and organized demanded to have provisions securing SDT for developing countries started in 1964 when the first conference of the UNCTAD was held. In this sense, the UNCTAD was aimed at restructuring the ITO Charter (Kasahara 2001: 25–6). In the following year, the GATT added provisions regarding trade and development, as Part IV of the General Agreement, with the strong backing of the UNCTAD. In response to the addition of Part IV, it was Australia that first provided preferences to developing countries on a non-reciprocal basis. The noteworthy change that took place with the addition of Part IV was the shift of relations between developed and developing countries from reciprocal to non-reciprocal relationships. Article XXXVI specifies that “developed countries do not expect reciprocity for commitments in trade negotiations to remove tariff and other barriers to the trade of the less developed contracting parties.”

Tissue (1987: 29) considers that the incorporation of Part IV introduced a radical change to GATT principles. Hudec (1987: 58) also points out that “the major significance of Part IV was its force as an agreed statement of principle.” At the level of rules, however, there was no immediate change because Part IV did not impose any legal obligations on developed countries to grant SDT to developing countries. Preferential trade arrangements in favor of developing countries were still a voluntary option. Delegates from developed countries tended to regard Part IV as a general and elusive declaration and, consequently, as having no value in a negotiating venue where governments dealt in concrete and meaningful trade actions (Hudec 1987: 58). In such circumstances, the enjoyment of the benefits of trade preferences for developing countries was very precarious. Subsequently, developing countries merged their different goals and aimed instead at obtaining legal grounds for a Generalized System of Preferences (GSP), which brought benefits to all developing countries, albeit to varying degrees. The fact that Part IV was not legally binding also led to legal instability for developed, preference-giving countries. They were still bound by their

10 The ITO Charter contained exceptional provisions in favor of developing countries that were approved because they were expected to help with the economic development of these countries. For example, Article XV of the ITO Charter provided that “new preferences could be granted in the interest of economic development or reconstruction of one or more of the parties.” However, these articles relating to developing countries were not included in the General Agreement (Hudec 1987: 7–18).

11 These movements had as their theoretical background the idea of international law of development. Tovias (1988: 513) describes the reason why SDT in favor of developing countries was accepted in the General Agreement: “because it was considered to be a step in the right direction, namely switching gradually from a principle of formal non-discrimination to substantive-discrimination.”
treaty obligations under Article I, and the implementation of a GSP would violate this MFN clause.

On June 25, 1971, the GATT granted a “waiver” for a ten-year period to developed, preference-giving countries which could justify their deviation from the MFN clause on the basis of having to implement a GSP. Soon after, the European Community (EC) put the first GSP scheme into operation, followed by Japan, the United States and other developed countries. However, the utilization of a waiver procedure, pursuant to Article XXV: 5, to approve a GSP implied that non-reciprocal preferential treatment was still considered a special case in the GATT legal system (Takashima 1995: 271). It was not until the adoption of the Enabling Clause in 1979 that developed countries could avoid criticism that they were deviating from their obligations under the MFN clause in giving SDT to developing countries.

In the 1960s and 1970s, the style of negotiations in the GATT was conditioned by the structural outline of contraposition between developed and developing countries. In order to introduce the new legal relationship embodied in the SDT concept, therefore, unified cooperation among developing countries was needed. However, differences among developing countries had the potential to weaken their bargaining power at the GATT. As a result, demands for SDT inevitably included the idea that developing countries should be treated as a unit and that every developing country could benefit from SDT, which meant non-discrimination among developing countries. A GSP scheme, through which developed countries would grant tariff preferences equally to all developing countries, albeit allowing for the possibility of providing more generous preferences to all least-developed countries, most clearly reflected this feature. Besides non-reciprocity between developed and developing countries, MFN treatment governing relations among developing countries was adopted as another operating principle of SDT.

III-2. The Introductory Process of the Enabling Clause

The Enabling Clause has created a permanent legal basis for SDT in favor of developing countries. However, it does not cover all forms of preferential treatment from developed to developing countries, being confined to only three types of trade preferences:

(a) preferential tariff treatment accorded by developed contracting parties to products originating in developing contracting parties in accordance with a GSP;

(b) regional and global arrangements amongst less-developed contracting parties for the

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12 The incorporation of a GSP into the GATT system was strongly attributed to the UNCTAD elaboration of the “Agreed Conclusion of the Special Committee on Preferences,” which initiated the establishment of GSPs in the global trading system.
mutual reduction or elimination of tariffs and non-tariff measures on products imported from one another;

c) special treatment for the least developed among the developing countries in the context of any general or specific measures in favor of developing countries.

The coverage of the Enabling Clause shows that it does not establish a legal basis for trade preferences from developed countries to limited groups of developing countries, even if they are formed for development-oriented purposes. Thus, the question arises as to why the Enabling Clause does not cover North-South RTAs. In order to clarify this issue, it is helpful to observe the process by which the Enabling Clause was finally incorporated into the GATT legal system.

The Enabling Clause was primarily aimed at granting a perpetual legal basis to two types of preference schemes—the GSP and trade preferences among developing countries—and the application of MFN treatment to these two schemes was waived for ten years from 1971. Because the waiver expiration date was approaching, the implementation of a GSP by developed countries and the exchange of tariff preferences among developing countries would be in violation of their treaty obligations. Therefore, there was a pressing need to find a way by which these preferences could be made compatible with Article I of the General Agreement. In this sense, the coverage of the Enabling Clause was strongly influenced by the fact that the GATT adopted waivers on MFN treatment in 1971.

When the GSP waiver was recognized, some developing countries brought forward an objection to the generalized system from which all developing countries could benefit evenly. Some limited groups of developing countries had already enjoyed preferential market access to developed countries. For example, eighteen African countries were allowed preferential tariff rates in the EEC markets through the Yaounde Convention, which was concluded in 1963. These countries were concerned about losing existing preferences and insisted that a GSP should provide them with at least equivalent advantages as compensation for sharing their preferential market with other developing countries and to redress any adverse effects resulting from the introduction of a GSP (Krishnamurti 1971: 50). In reality, they might want to call for SDT on North-South preferential arrangements for limited group of developing countries. However, the African countries finally accepted the generalized form of preferences in order to establish a GSP in the GATT framework.

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13 The Yaounde Convention was an ancestor to the Lomé convention. Eighteen members are former African colonies of EEC member states: Burundi, Central African Republic, Cameroon, Chad, Congo (Brazzaville), Congo (Kinshasa), Dahomey, Gabon, Ivory Coast, Madagascar, Mali, Mauritania, Niger, Rwanda, Senegal, Somalia, Togo, Upper Volta. These African countries set up the “Associated African States and Madagascar (AASM).” However, because this agreement was based on the principle of reciprocity, members of AASM had to undertake obligations to provide preferences on imports from the EEC (Maeda 2000: 17–20).
For developing countries as a whole, the highest priority was put on the introduction of a GSP.

The number of North-South RTAs was still very small after the waiver for a GSP was approved, even though some cases existed, such as the arrangement of the first Lomé Convention between the EC and African, Caribbean and Pacific (ACP) countries in 1976. At the time, North-South preferential schemes were not such a hot item.\(^\text{14}\) Therefore, there was almost no discussion in the GATT as to whether North-South RTAs should be covered by the Enabling Clause.

So, why were South-South RTAs, let alone a GSP, included in the Enabling Clause? In the context of SDT, much more attention was likely to be paid to a GSP than preferential arrangements among developing countries. However, the latter were deemed to have a significant effect on economic development\(^\text{15}\) and were concluded in 1965 after the addition of Part IV to the General Agreement. For example, India, the United Arab Republic (present Egypt) and Yugoslavia signed a preferential trade agreement on December 23, 1967.\(^\text{16}\) Another example, evaluated as “the most important preferential arrangement among developing states concluded within the framework of the GATT” (Yusuf 1980: 491), was the Protocol Relating to Trade Negotiations among Developing Countries (PTN), which was enforced in 1973. These two arrangements were not intended to fulfill the criteria for forming a CU or an FTA as stipulated under Article XXIV. Nor did Part IV of the GATT grant any legal basis for preferential arrangements among developing countries. A working party was established at the GATT to discuss the measures to be taken regarding a preferential trade agreement among India, the United Arab Republic and Yugoslavia, and the GATT permitted these countries to proceed with their agreement by a 1968 decision but not by granting a waiver (GATT 1969: 17).

It is impossible to compare RTAs among developing countries with RTAs among developed countries. Developing countries have come to demand that their RTAs should be authorized even when they fall short of the conditions stipulated in Article XXIV. Moreover, when Part IV of the General Agreement came into force, a distinction was made between the possible systems applicable to negotiations between developed and developing countries and those applicable to negotiations among developed countries. Similarly, GATT members recognized the need to apply different criteria to each case in the context of RTAs rather than to apply absolute and general rules (Espiell 1971: 38). The provisions for RTAs among developing countries were inserted into the

\(^{14}\) It was after the Enabling Clause was introduced that attention was paid to the Lomé convention for its geographical discrimination (Tovias 1988: 504).

\(^{15}\) As mentioned in Part II, the first advocates of preferential trade arrangements in the drafting process of the General Agreement were developing countries.

\(^{16}\) These countries presented the agreement to the GATT as “a modest pioneering effort in trade expansion” which had “evolved in pursuance of obligations under Part IV of the Agreement” (Yusuf 1980: 489).
Enabling Clause in order to confirm the operation of existing preferences among these countries.

By contrast, some believe that North-South RTAs provisions were intentionally excluded from the Enabling Clause.\textsuperscript{17} If the Enabling Clause covers both South-South and North-South RTAs, two conditions should be necessary. The UNCTAD, which was the main proactive institution to insert the Enabling Clause into the GATT system, did not insist on differentiation among developing countries, and developing countries did not necessarily stand together regarding the provision of North-South preferences to limited groups of developing countries.\textsuperscript{18} Consequently, developing countries started their struggle to obtain SDT with South-South RTAs, while North-South RTAs were excluded from the negotiations on the Enabling Clause from a strategic viewpoint.

International organizations, especially the UNCTAD, continued to take a negative stance toward differentiation among developing countries. If North-South RTAs were excluded from the coverage of the Enabling Clause for strategic reasons, it is difficult for SDT to be introduced into North-South RTAs on the initiative of the UNCTAD. On the other hand, if North-South RTAs were not intentionally excluded from the Enabling Clause, the applicability of SDT to North-South RTAs is open to question, because the situation has changed considerably and the number of North-South RTAs is rapidly increasing.

\section*{IV. Practices of North-South RTAs in the WTO System}

In the current world trade system, there are non-generalized and non-reciprocal preferential agreements between developing and developed countries. Such agreements are not RTAs categorized in Article XXIV; nor are they generalized preferential schemes justified by the Enabling Clause. A representative example is the Cotonou Agreement, a successor to the Lomé Convention, which was signed by the EC member states and the ACP countries.\textsuperscript{19} In addition, the United States offers duty-free non-reciprocal access to most Caribbean and sub-Saharan countries through the US-Caribbean Basin Economic Recovery Act (CBERA) and the African Growth and Opportunity Act (AGOA), both of which were enacted under federal US law. In this part, the focus of the paper turns to how these trade arrangements remain compatible with WTO rules.

\textsuperscript{17} Interview with a UNCTAD official, November 2003.
\textsuperscript{18} When the Yaounde Convention negotiations started, some developing countries feared that they would be bypassed by the institutionalization of a system of preferences. As a representative of excluded countries, India objected that “the negotiations that are taking place with a view to association of the 18 African and Malagasy states with the EEC are a deviation from GATT rules” (Tussie 1987: 28).
\textsuperscript{19} Currently the ACP group consists of seventy-seven members.
IV-1. The Lomé Convention and the Cotonou Agreement

In 1975, the EC and the ACP countries concluded a framework agreement known as the Lomé Convention, which has subsequently provided the structure for trade and cooperation between these two groups. This convention was designed on the basis of the EC’s aid policy for the ACP countries (former colonies of some EC member states). Since 1975, the Lomé Convention has been renewed four times in order to strengthen the integration of ACP states into the global economy. The last agreement under this name (Lomé IV) expired at the end of February 2000 and was replaced by an agreement which serves as the framework for new and more comprehensive relations between the EC and the ACP countries. This new agreement, known as the ACP-European Union (EU) Partnership Agreement, was signed in Cotonou, Benin, on June 23, 2000.20

The main objective behind the Lomé Convention was not to form a free trade area in terms of Article XXIV but to lay the legal foundation for a development assistance scheme from the EC to the ACP countries. Therefore, the Lomé Convention set up a preferential and non-reciprocal trading system favoring the ACP countries by allowing them almost free access to EC markets for nearly all industrial goods and for a wide range of agricultural products. Moreover, regarding banana imports, in accordance with the Lomé Convention, the EC granted preferential trade arrangements to ACP countries by imposing no duties and introducing a preferential quota only for ACP countries.21 However, these preferences became the subject of arguments as to whether they violated MFN treatment. In April 1993, five Latin American countries22 filed a compliant before the GATT concerning the EU’s banana import regime.

In the banana dispute, there were two points of debate concerning North-South RTAs: firstly, whether the Lomé Convention fell under the category of free trade areas defined in Article XXIV; and secondly, whether Article XXIV: 8, which provides essential requirements for free trade areas, could be interpreted as adhering to the spirit of Part IV of the GATT.23 Based on the GATT Dispute

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20 The official name of this agreement is Partnership Agreement between the Members of the African, Caribbean and Pacific Group of States of the One Part, and the European Community and Its Member States, of the Other Part. The Agreement entered into force in June 2000 and will be valid for a period of twenty years, subject to revision every five years.

21 The EU has allowed a significantly larger amount of imports from ACP producers because of a historical relationship between the exporting countries and European nations. Carew (2002) considers “the fact that the preference exists for ACP producers is a remnant of European colonial policy. The EU is bound to this policy by the Lomé convention.”

22 The members who requested the panel were Colombia, Costa Rica, Guatemala, Nicaragua and Venezuela.

23 Five Latin American countries claimed that the EEC measures were not justified under Article XXIV, since the Lomé Convention did not meet the conditions of a free trade area as set out in that Article. The claim of the EEC was that its banana import measures, even if inconsistent with Article I, were justified under the provisions of Article XXIV and, also, that the conditions set out in Article XXIV: 8(b) had to be read in the light of Part IV of the General Agreement.
Settlement Rules and Procedures, a panel was established to examine these matters, and it concluded that the EU’s preferences for ACP countries constituted Article I MFN violations and, as such, could not be justified on the grounds of Article XXIV (GATT 1994). The panel also deemed that Article XXIV: 8 could not be read in conjunction with Part IV. On the first issue, the panel described its reasoning—that the Lomé Convention was a non-reciprocal agreement which do not meet the definition of a free trade area in the sense of Article XXIV—in the following manner:

[T]he use of the plural in the phrases “between the constituent territories” and “originating in such territories” made it clear that only agreements providing for an obligation to liberalize the trade in products originating in all of the constituent territories could be considered to establish a free-trade area within the meaning of Article XXIV:8(b). … The [Lomé] Convention … did not provide for any liberalization of trade in products originating in the EEC. … This lack of any obligation of the sixty-nine ACP countries to dismantle their trade barriers, and the acceptance of an obligation to remove trade barriers only on imports into the customs territory of the EEC, made the trade arrangements set out in the Convention substantially different from those of a free trade area, as defined in Article XXIV:8(b).

(GATT 1994: paragraph CLIX)

As to the relationship between Article XXIV and Part IV, Article XXXVI: 8 limits the right of developed contracting parties to demand reciprocity from developing contracting parties in procedures under the General Agreement. The panel interpreted the phrase, “in procedures under the General Agreement,” as not including procedures leading to the formation of a non-reciprocal free trade area between developed and developing countries (GATT 1994: paragraph CLX).

Moreover, the panel made reference to a previous panel report which stated that the spirit and objectives of Part IV could not be cited as justification for actions violating obligations under Part II.24 The view of the panel was that:

Article XXXVI:8 and its Note were not intended to apply to negotiations outside the procedural framework of the General Agreement, such as negotiations of a free trade area. … That [previous] panel had found that the provisions of Part IV cannot override obligations, in particular the obligation to accord most-favoured-nation treatment, owed under other parts of the General Agreement. … [T]he wording and underlying rationale of Article XXXVI:8 and its Note, and also its drafting history and subsequent interpretation in GATT practice, made clear that it was neither intended to modify Article XXIV:8(b) nor to justify preferences inconsistent with Article I:1 other than those specially provided for in Article XXIV.

(GATT 1994: paragraph CLXI, CLXII)

24 The panel noted the drafting history of Part IV of the GATT as supporting its interpretation. During the negotiations of Part IV, the authorization of special preferences to developing countries had been suggested but had not been included in the final text, which, according to the panel, meant that non-reciprocal agreements between developed and developing countries had not been considered justifiable in the provisions of Part IV (GATT 1994: paragraph CLXII).
After the release of the panel report on the banana dispute, the EU and ACP countries requested that a waiver be granted for the Lomé Convention based on the procedures of Article XXV of the General Agreement, and this waiver was granted by the WTO until the Lomé Convention was replaced by the Cotonou Agreement in 2000.\textsuperscript{25}

Even though EU member states undertook a fundamental review of their relationship with ACP countries when they replaced the Lomé Convention, they still considered the Cotonou Agreement as a part of their policy to aid and assist in the development of those countries.\textsuperscript{26} Consequently, the Cotonou Agreement inherited the non-reciprocal preferential trade arrangement from the Lomé Convention, which was incompatible with WTO rules. In order to avoid a recurrence of the same disputes that had plagued the Lomé Convention, participants to the Cotonou Agreement obtained a seven-year waiver from WTO rules at the Doha Ministerial Conference in November 2001. However, most parties to the Cotonou Agreement anticipated much difficulty in renewing the waiver owing to the deep-rooted criticism against preferential trade arrangements from GATT contracting parties who had been excluded.\textsuperscript{27} Before 2008, therefore, the Cotonou Agreement would have to be made into a new agreement compatible with WTO rules. The EU proposed to replace preferential trade provisions in the Cotonou Agreement with reciprocal free trade agreements (FTAs) in order to meet the requirements of Article XXIV. Because of the difficulties involved in concluding one broad FTA among all the countries concerned, the new scheme divides the ACP countries into seven groups by region, with FTAs concluded between the EU and each of these groups. The first phase of negotiations between the EU and ACP countries as a whole, in which all participants reached an agreement in principle on shifting the Cotonou Agreement toward separate FTAs, was carried out from September 2002. The second phase of negotiations, between the EU and each of the seven groups, began in October 2003 and is currently ongoing.

\textbf{IV-2. CBERA}

\textsuperscript{25} The GATT members decided that “the provisions of paragraph 1 of Article I of the General Agreement shall be waived, until 29 February 2000, to the extent necessary to permit the European Communities to provide preferential treatment for products originating in ACP States as required by the relevant provisions of the Fourth Lomé Convention, without being required to extend the same preferential treatment to like products of any other contracting party” (GATT 1994).

\textsuperscript{26} The EU explained the reason for reconsidering the Cotonou Agreement as a result of a fundamental turnaround of EU trade and aid policy and not as a result of the agreement’s incompatibility with WTO rules. The EC started a comprehensive approach to assist in the economic development of developing countries not only in trade but also in other fields, such as finance and human resource development, which made it necessary to revise the Cotonou Agreement (Interview with an EU official, November 2003).

\textsuperscript{27} Under article XXV of the General Agreement, a waiver requires approval by a two-thirds majority of the votes cast and one-half of the contracting parties.
The CBERA, commonly referred to as the Caribbean Basin Initiative (CBI), was enacted as a domestic law of the United States in August 1983 and was implemented from 1984. It authorizes the United States to provide unilaterally to eligible Caribbean countries preferential trade and tax benefits including duty-free access to the US market for eligible products. Its main objective is to help the Caribbean Basin countries diversify their economies and expand their exports (USTR 1999: 8). Twenty-four countries and territories are currently designated as beneficiaries corresponding to the purpose of the CBI.

At the inauguration of the CBI scheme, the United States sought a GATT waiver for its obligations under Article I because the application of the CBI would potentially constitute an MFN violation. In addition, the Enabling Clause did not justify geographically-limited preferences such as the CBI (Jacobs et al 2000:2–3). There was much deliberation in the examination of the proposed CBI waiver under the GATT, but with the strong support of the beneficiary countries and territories, the United States successfully received a waiver of Article I in 1984. The waiver has been renewed several times and is currently valid until December 31, 2005 (WTO 1995b).

One of the key questions surrounding the CBI has concerned the eligibility criteria for designation as a beneficiary country. On the basis of the CBI criteria, not only Asian or African countries but also several Central American and Caribbean countries were excluded from CBI benefits. Some GATT members have claimed that such exclusions were incompatible with MFN treatment and even Part IV of the General Agreement, which aims to promote the economic development of all developing countries. Although they regard the CBI objective of promoting economic and political stability among the Caribbean Basin countries as desirable, other GATT member countries, especially those excluded, have argued that this objective should not be viewed as sufficient justification for a waiver (South-North Development Monitor 1984).

Some members have further stated that they prefer the strengthening of a GSP as the best way of promoting trade by developing countries. However, during the examination of the proposed CBI waiver, the United States argued that the CBI was one element of its GSP scheme. The US view

28 The Act was originally scheduled to remain in effect until September 30, 1995, but was amended in 1990 by the Caribbean Basin Economic Recovery Expansion Act, known as CBERA II or CBI II, in order to make the CBERA a permanent program. Moreover, in May 2000, the U.S.-Caribbean Trade Partnership Act (CBTPA) was enacted, thereby expanding the list of duty-free products and offering greater access to the US market for eligible countries.

29 Presently, the eligible countries are Antigua and Barbuda, Aruba, Bahamas, Barbados, Belize, Costa Rica, Dominica, Dominican Republic, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Montserrat, Netherlands Antilles, Nicaragua, Panama, St. Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Trinidad and Tobago, and the British Virgin Islands.

30 Jacobs et al (2000: 3) point out that the quota-free provisions and the tariff-rate quotas in the CBI involve discrimination under Article XIII and that the United States needs to request a waiver of Article XIII for these provisions and quotas.

31 For details of discussions with respect to the first CBI waiver, see South-North Development Monitor (1984).
was that its special preferences under the CBI could be covered by the Enabling Clause. In response to this stance, the GATT secretariat suggested that “the Enabling Clause covered only specific arrangements laid down in it and not those envisaged under CBERA” (South-North Development Monitor 1984). At present, the United States distinguishes the CBI from a GSP in the following terms: “The CBI program is … independent of the U.S. GSP program as a matter of statute and a matter of policy” (WTO 1995a).

IV-3. AGOA

The AGOA is a constitutive part of the US domestic legislation, entitled the Trade and Development Act of 2000, which also contains the CBI scheme. The Act identifies certain sub-Saharan African countries as being eligible for AGOA benefits and offers them preferential access to the US market. Specifically, the AGOA expands the list of duty-free products under the GSP program of the United States only for AGOA eligible countries, as well as quota-free exports of textile and apparel products to the United States (Washington Trade Report 1999).

Along with the CBI, the objective of the AGOA itself is generally considered positive. However, several issues of concern have arisen. In terms of WTO compatibility, the AGOA faces problems because beneficiaries have been chosen in a limited and arbitrary manner. The criteria for eligibility under the AGOA are divided into two stages. Firstly, the AGOA extends the possibility of favored trade status in accordance with geographical criteria, or forty-eight sub-Saharan African countries. Secondly, the AGOA recognizes a country as eligible when the governments of these countries follow the pre-determined social and economic criteria. To be eligible, a country must have established or be making continual progress toward establishing: a market-based economy, the rule of law, the elimination of barriers to US trade and investment, economic policies to reduce poverty, the protection of internationally-recognized worker rights, and a system to combat corruption. Additionally, a country is examined to see whether it adopts policies that: do not interfere with US national security or foreign policy, do not violate internationally-recognized human rights, do not support international terrorism, and eliminate the worst forms of child labor (USTR 2003: 9). In the WTO trade policy review of the United States, the EC points out that “the eligibility to AGOA is not only dependent on objective criteria related to the development status of 32 The Act entered into effect in October 2000 and will continue until September 2008.
33 Skeptical views of the AGOA have appeared in various fields. Apart from doubts over its compatibility with the WTO, the issue of rules of origin is the most controversial problem. For details on this matter, see Flatters (2002).
34 Under the AGOA, for their eligibility status to be determined, forty-eight potential beneficiaries have their cases reviewed annually. For 2003, thirty-eight countries met the requirements, up from thirty-six previously (WTO 2003b: 26).
individual countries.” Where political and non-objective criteria are used to determine AGOA benefits, the EC is skeptical of whether these criteria are “square with the applicable WTO rules governing such arrangements” (EC 2004).

Like the CBI, the AGOA offers a more expansive range of duty-free treatment than a GSP (Washington Trade Report 1999), which means that the AGOA program is sometimes regarded as an extended version of a GSP scheme. The AGOA program, however, does not apply to all developed or least developed countries. Moreover, if the AGOA were to be modified in the same way as the GSP of the US, the US, as a WTO member, would have to notify the relevant changes to the CTD, which is in charge of GSP schemes. However, there is no report from the United States regarding such a modification. Thus, the AGOA can be recognized as a non-reciprocal and geographically-based preferential trade arrangement which needs a WTO waiver. As with established practices in the CBI and other preferential schemes for limited groups of developing countries conducted by the United States, it is most likely that the United States will request a waiver for the AGOA. When the AGOA scheme was introduced, the US government also showed its intention to obtain a waiver for the AGOA’s preferential access provisions (Jacobs et al 2000:3–4). However, as of June 2003, the United States has not yet requested a WTO waiver for the AGOA (WTO 2003b: 26).

Interestingly, the AGOA also contemplates the future negotiation of an FTA between the United States and AGOA beneficiaries, but as yet no action toward negotiations on such an agreement has started (Washington Trade Report 1999). It remains to be seen whether the United States has a strategy or intention to change preferential trade arrangements into FTAs in order to achieve consistency with WTO rules. However, this would be one of several possible ways for non-reciprocal North-South RTAs to be authorized in the WTO legal framework.

V. North-South RTAs and Issues of WTO Compatibility

In view of the current legal system of the WTO, it is impossible not to conclude that specific trade preferences for limited groups of developing countries are incompatible with WTO rules. Countries concerned with North-South RTAs, therefore, have strived to create various measures in order to achieve compliance with the WTO.

35 Interview with a WTO official, November 2003.
36 Interview with a WTO official, November 2003.
V-1. Possible Options for WTO compatibility

The essential characteristics of North-South preferential schemes, which provide benefits to limited groups of developing countries, are their non-generalized and non-reciprocal features. The former feature excludes such North-South RTAs from the coverage of the Enabling Clause. On the other hand, due to the second feature, North-South RTAs cannot fulfill the criteria of FTAs as stipulated in Article XXIV. Therefore, North-South RTAs inevitably come into conflict with Article I. There are three possible ways for states to justify their preferential schemes as deviations from MFN treatment: (a) by obtaining a WTO waiver pursuant to Article XXV: 5; (b) by extending specific preferences to all developing countries; and (c) by creating free trade areas, as specified in Article XXIV.

In the past, countries have maintained these specific preferences usually by obtaining waivers. However, gaining a waiver under the WTO has lately become a more difficult process. This is partly because in 1995 the reform of the GATT into a new institution, the WTO, brought about the enhancement and expansion of the “rule of law.” As a result, there was an increasing belief that exceptions which could erode the legal system had to be restrained minimally. Even if the WTO grants waivers for North-South RTAs, the waiver period is now shorter than most cases in the past. Those preferential schemes that have not yet received waivers are likely to be examined by the Dispute Settlement Body (DSB) for their consistency with WTO rules.37

The second option for attaining WTO compatibility for preferential trade schemes has become of little effect. GSP preferences are to be non-discriminatory across developing countries except for those favoring the least developed countries (LDCs). In order to assimilate geographically-limited preferences into GSP schemes, some preference-giving countries have attempted to generalize these schemes. The Everything But Arms (EBA) initiative of the EU, which grants duty- and quota-free access for all goods exported by LDCs, and the AGOA scheme of the United States are often cited as prominent examples (FAO 2003; Hoekman et al 2003: 5–6). However, such schemes should be distinguished from the generalization of North-South RTAs. The EBA precludes advanced developing-countries that are eligible for the Cotonou Agreement, and the AGOA limits its geographical range to sub-Saharan African countries. Moreover, both sides to North-South RTAs share negative views about the extension of limited preferences to all developing countries. Developing countries might lose existing preferences. On the other hand, developed countries might

37 For instance, India called for the establishment of a panel under the DSU that would examine the EU’s special tariff preferences to the so-called Drug Arrangements, under which only twelve developing countries could benefit. The WTO issued a panel report on December 1, 2003, and found the EU’s arrangement to be in violation of trade rules because it discriminated against other developing countries (WTO 2003a).
lose their strategic measures for assisting specific groups of developing countries.

In these circumstances, countries in recent years have actively attempted to substitute specific preferences with free trade areas, which are officially permitted in the WTO system. The EU’s policy to replace the Cotonou Agreement by seven FTAs is a good example. The United States also considers the AGOA as a first step toward FTAs with sub-Saharan African countries (IPC 2003: 2). However, the criteria for concluding FTAs are not defined precisely, and the examination mechanism for determining their consistency with WTO rules does not function properly. In addition, some degree of “flexibility” is permitted in FTA practices, which makes it likely that WTO members will utilize FTAs as a tool for obscuring the incompatibility of North-South RTAs with WTO rules.

V-2. Flexibility in North-South RTAs

North-South RTAs would be approved as FTAs only if all participants reciprocally liberalized their trade practices. However, it is difficult to apply symmetrical obligations, such as tariff elimination, among participants which are unequal in the terms of economic strength. Thus, developing countries, in particular ACP countries, often request limitations to the degree of reciprocity in FTAs or seek techniques to avoid granting full reciprocity. As Onguglo and Ito (2003: 1) point out, “there exists a legal lacuna in terms of availability of SDT” in respect to North-South RTAs. Past experiences in the WTO suggest that a certain degree of flexibility is allowed in the formation of North-South RTAs. For example, a transitional period of twelve years is provided in the framework of the FTA between the EU and South Africa (Bilal 2002: 5–6). In the cases of the EU-Tunisia FTA and the Canada-Chile FTA, developing countries are permitted to take more than ten years for liberalization and set aside sensitive products from their liberalization list, whereas developed countries have to liberalize immediately on substantially all the trade.

The concept of flexibility is legally based on the term “exceptional cases” in the Understanding on the Interpretation of Article XXIV. Paragraph 3 of the Understanding states that “[t]he ‘reasonable length of time’ referred to in paragraph 5(c) of Article XXIV should exceed 10 years only in exceptional cases” (author’s italics). In Article V paragraph 3 of the GATS, moreover, the term “flexibility” for developing countries is explicitly mentioned:

Where developing countries are parties to an agreement of the type referred to in paragraph 1, flexibility shall be provided for regarding the conditions set out in paragraph 1, particularly with reference to subparagraph (b) [this means the condition “a reasonable length of time”] thereof, in accordance with the level of development of the countries concerned both overall and in individual
sectors and subsectors.

The GATS, however, does not characterize the available flexibility. Consequently, while the SDT for developing countries is recognized in RTAs on services, its practical usage remains unspecific (Bilal 2002: 6).

Like the situation in the GATS, it is matter of argument as to the condition in Article XXIV to which flexibility applies.\(^{38}\) Judging by the precedents, flexibility applies mostly in two spheres: in the transition period and in the product coverage. The former allows deviations under the “reasonable length of time” condition, while the latter allows deviations under the “substantially all the trade” condition. The view of the CRTA, however, is that the concept of flexibility applies only in the transition period and that the issue of product coverage is outside the scope of flexibility.\(^{39}\) In accordance with this view, not a few cases of RTAs have persuaded longer time frame as a transitional period than ten years without a waiver. On the contrary, even though the flexibility in product coverage constitutes de facto acceptance of SDT, no legal guarantee is given in respect to the compliance of these provisions with WTO rules. There is much skepticism on flexibility in product coverage as neglect of an Article XXIV requirement.

Besides the ambiguity of the flexibility concept and lack of any mechanism to ensure effective implementation of SDT, what makes the legal framework on RTAs even more obscure is that both available rules for North-South RTAs—those on RTAs and those on SDT—are under review in the ongoing multilateral trade negotiations of the so-called Doha Development Agenda (the New Round).\(^{40}\) The form and content of RTAs currently under negotiation or consultation will be influenced by the outcome of this New Round. In reviewing RTA rules, “the negotiations shall take into account development aspects of regional trade agreement” (WTO 2001b: paragraph 29). This provision reflects a concern by certain developing countries that are eager to introduce more flexibility into rules relating to North-South RTAs (Bilal 2002: 6). Interestingly, the request to apply some SDT provisions to North-South RTAs was proposed at the Seattle Ministerial Meeting in 1999.\(^{41}\) This proposal, however, was not adopted as part of the agenda at that conference. But

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38 Onguglo and Ito (2003: 49–63) divide the concept of flexibility into two categories: “existing flexibility” and “additional flexibility.” They argue that SDT for developing countries falls under the latter type of flexibility. They also examine the modalities for granting additional flexibility in respect to each condition of Article XXIV.

39 Interview with WTO officials, October 2003.

40 The ministers at the Doha Ministerial Conference in 2001 mandated the CTD to examine STD provisions with the phrase that “all special and differential treatment provisions shall be reviewed with a view to strengthening them and making them more precise, effective and operational” (WTO 2001b: paragraph 44). According to this declaration, the CTD has to consider measures or mechanisms to enhance SDT provisions. So far, the CTD has divided various proposals relating to SDT into three categories so that it can establish the priorities for strengthening the STD provisions.

41 Interview with a WTO official, November 2003.
developing countries have strongly demanded the enhancement of SDT regularly (WTO 2001a). Their requirement is based on the idea that SDT provisions “are to be looked at not as exceptions to the general rules but more importantly as an integral and inherent objective of the multilateral trading system” (WTO 2001a). It is difficult to infer even the outline of a set of relevant rules from the current status of negotiations.

V-3. The Concern about Differentiation

The introduction of an SDT clause in Article XXIV would have a negative impact in one sense. It would lead to a segmentalization of preferential schemes which would result in dividing legal disciplines into pluralistic pieces. It could trigger exclusive trading blocs also involving developing countries. One of the most problematic issues is that it would provide an explicit legal base to the de facto differentiation among developing countries. Panagariya (2002) is concerned that “the preferences also became an instrument of breaking the united front presented by a group of developing countries.”

The traditional approach toward development issues in the GATT/WTO still emphasizes that developing countries need appropriate strategies as a package rather than strategies that focus on sectoral and divisive programs such as the Cotonou Agreement, the CBI and the AGOA. From a poverty-reduction point of view, there is alarm that “preferences should focus on the poor, wherever they are geographically located, and not on a limited set of countries. … Limiting preferences to LDCs or concentrating on a specific geographic region such as sub-Saharan Africa ignores the majority of the poor in the world today” (Hoekman et al 2003: 6). Even if differentiation between developing countries is necessary, the preferences for development are to be accorded not because of political, cultural or even geographical ties, but because of the difference in the levels of economic development (Yusuf 1980: 492).

By contrast, others point out the positive effect of differentiation between developing countries. Many of the preference-receiving developing countries have benefited substantially from gaining preferential access for their exports. These trade preferences were originally conceived as a means to increase production and exports of developing countries so that they would eventually become

42 In order to realize their goals, developing countries proposed the establishment of a concrete and binding SDT regime that would be responsive to their development needs. They also requested WTO members to elaborate a framework/umbrella agreement on SDT (WTO 2001a).

43 Panagariya (2002) fears that inter alia such differentiation by preferences would be utilized by developed countries to break the generally unified position of a large majority of developing countries against Singapore on issues like the inclusion of labor standards into WTO agreements.
more competitive internationally (FAO 2003). As the distinct qualities of WTO members, such as economic strength and human resource skills, become diversified, the capacity to implement WTO disciplines will vary from country to country. Advocates regard these circumstances as a rationale for differentiation between developing countries in determining the reach of resource-intensive WTO rules (Hoekman et al 2003: 16). The issue of differentiation is not peculiar to South-North RTAs. It is difficult to find the necessary unity to resolve intertwined and implicated agendas among countries with conflicting interests as found in the WTO.

IV. Concluding Remarks

Recently, there has been a surge in bilateral and regional trade arrangements between developed and developing countries. These arrangements are known as North-South RTAs. In connection with these RTAs, a question arises as to what kinds of rules are applicable to such arrangements. Under the current WTO legal system, RTAs involving trade in goods are largely governed by Article XXIV of the General Agreement, while RTAs in services are governed by Article V of the GATS. RTAs are by definition discriminatory. This means they inevitably violate the MFN obligation, which is the fundamental principle of the WTO. However, many WTO members regard RTAs as necessary to develop or reconstruct their economies. In order to justify such MFN violations, therefore, each set of rules on RTAs has been incorporated into the General Agreement and the GATS.

Besides these provisions, another provision applying to RTAs among developing countries is the Enabling Clause. The Enabling Clause stemmed from the ambitious quest of developing countries during the 1960s to gain SDT within the multilateral trading system. These countries firstly materialized the GSP schemes among their overall demands, under which the developed countries could grant preferential market access across all developing countries by unilaterally reducing tariffs despite the conflict between these schemes and the MFN clause. With the intention to introduce GSP schemes into the GATT legal framework, the GATT member-states approved GSPs as an exception to MFN treatment through a ten-year waiver in 1971 and, in effect, provided

44 Preferences are effective, especially in the field of agriculture. An FAO report pointed out that trade preferences have benefited many countries in developing their agricultural exports as a major source of foreign exchange.

45 Hoekman et al (2003: 16) further proclaims that “some WTO disciplines may not be appropriate for very small countries in that the regulatory institutions that are required may be unduly costly.” They lay out the basic rationale for differentiation, which is that “certain agreements may simply not be development priorities or they may require many other preconditions to be satisfied before implementation will be beneficial.” These predictions can be required in proportion to per capita income, institutional capacity and economic scale, instead of being applied across the board.
a permanent waiver in 1979 through the Enabling Clause. This clause also covers SDT in those RTAs that consist of only developing countries.

Article XXIV of the General Agreement and Article V of the GATS set out several criteria for forming RTAs. These are: a “substantially all the trade” condition, a “reasonable length of time” condition, and the condition that there should be reciprocal liberalization among constituents. On the other hand, the Enabling Clause provides legal status only for generalized and non-reciprocal schemes, not for schemes that select only some developing countries. According to current WTO rules, North-South RTAs, unlike GSP schemes, must be reciprocal and must cover substantially all the trade. Special preferential schemes of the past were mainly implemented by the EC and the United States. The EU’s arrangement, which only applies to ACP countries, began with the Lomé Convention (now the Cotonou Agreement), while the United States established the CBI and the AGOA (legislated as national law), which benefits Caribbean or sub-Saharan countries through a discriminatory tariff measure. None of these specific trade preferences, which are aimed at limited groups of developing countries, meet the criteria stipulated in Article XXIV, and hence all preferences need a waiver from WTO rules.

The usual practice has been for the countries concerned to maintain their special trade preferences by obtaining a waiver. However, in recent years, obtaining waivers from the WTO has become more difficult, and, as a consequence, the countries involved have replaced trade preferences by concluding FTAs. However, such FTAs are also problematic. Firstly, the concept of flexibility is less than obvious. Member countries could exploit this concept and end up neglecting the WTO legal framework. Moreover, available disciplines on North-South trade arrangements—rules on RTAs and SDT—are on the negotiating table at the New Round, and so the outcome of this Round will impact upon the content of North-South RTAs. However, there is no way of knowing the kind of agreement that might be reached at the New Round; therefore, it is unclear what rules will apply to North-South RTAs in the future.

Another problem is that the approval of SDT for the provision of special preferences to some developing countries could provide a legal foundation for differentiation between developing countries. If SDT provisions are incorporated into the North-South RTA rules, preferences for development could be provided not on the basis of MFN treatment, but on the basis of geographical or other arbitrary criteria. However, the provision of preferences to a limited number of countries makes deviation from SDT an issue fundamental to the debate of how preferences should be provided to developing countries. So far, SDT has been seen as a way to improve the competitive position of developing countries. Instead, the position of developing countries might be weakened if some developing countries get special preferences. As such, there needs to be a deep and
comprehensive discussion on how to fulfill the lack of SDT in North-South RTAs.
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Rules of Origin: Implementing Change
New Zealand Experience
APEC RTA / FTA RoO Workshop, February 2006
What is the purpose of a Free Trade Agreement?

- Liberalise & facilitate trade
- Eliminate tariffs
- Open new market opportunities
- Provide a framework for cooperation
Only the Parties to the agreement are able to benefit from it

Rules should be:

- Simple / Robust
- Easy & economical to administer
- Business friendly
- Fair
- Consistant
New Zealand Experience

- CER – 20+ years
- Singapore (ANZSCEP) All use RVC
- Less / Least Developed
Successful or Not?

Business feedback

Compliance monitoring
How do we fix it?

*Change the rules to reflect trading environment*

- Less complex
- Simplify accounting requirements
- Consistency
- Remove Xrates from the equation
NZTCEPA experience

- New rules easy to understand
- Easier to acquire information
- Fairer to all business
- Consistant - Once qualify, always qualify
- Customs – no issues
  - Simple classification of non-originating inputs
Implementation – to do list

- Develop new policies and procedural instructions
- Amend legislation
  - Customs Act
  - Regulations
  - Tariff
- Prepare information material
- Inform traders
- Train Customs staff
- Risk management - verification
Business Outreach

Identify Interested Parties

- Traders
- Manufacturers
- Business associations
- Customs brokers
Administration Experience

- Training

- Monitoring / Verifying / Reporting

- Targeted assistance to business
Do they have a place in the verification process?
The business community and Customs must understand

- Objective of the agreement
- Rules of Origin & verification procedures
- Administration of the agreement
- Communication

APEC Workshop on Best Practices
Hanoi, 28 February 2006

APEC work program on RTAs/FTAs

Chris DeCure
Chair, Committee on Trade and Investment (CTI)
Importance of RTAs/FTAs to APEC

2005 Leaders’ Declaration:

- High-quality RTAs/FTAs important avenues to free and open trade and investment
- Continue to pursue high quality, transparency and broad consistency in RTAs/FTAs in the region
APEC Best Practices

- Adopted in 2004
- Support achievement of Bogor Goals, are consistent with, and build on existing WTO commitments
- Do not prescribe content of agreement
- Reference tools for WTO negotiations to clarify and improve existing WTO rules
Model measures for RTAs/FTAs

- Part of more comprehensive APEC work plan on RTAs/FTAs
- Build on the Best Practices
- Encourage high-quality and comprehensive approach to design and content of free-trade agreements
- To be completed by 2008 for as many RTA/FTA chapters as possible
Model measures for trade facilitation in RTAs/FTAs

- First set of model measures, adopted in 2005
- Help APEC members to formulate effective trade facilitation provisions
- Not mandatory and prejudicial to future FTA or WTO negotiations
CTI work program on RTAs/FTAs

- Assist in developing model measures by 2008 in accordance with ministerial mandate
- Develop mechanism for cataloguing RTAs/FTAs with respect to Best Practices
- Capacity-building activities
Models for Services Negotiation in RTA/FTA:
Options for Developing Countries
Structure of Presentation

I. General Issues
II. Typical Negotiating Modalities
III. Options for Developing Countries
GENERAL ISSUES

• Why services matter?
• Overview of relevant WTO rules
Importance of Service Sectors in Economy

Why services matter to developing countries?

• Complement and strengthen modern domestic economic infrastructure for economic and social welfare.

• Add value to and enhance competitiveness of manufactured, agricultural and mining products

• Facilitate transfer of technology and knowledge
Why services matter to developing countries? (cont.)

• Create labor-intensive and knowledge-based jobs

• Attract investment

• Export of services are increasingly important in trade benefits. Potential economic gains are substantial

Estimated liberalization of services in developing countries could provide as much as $6 trillion in additional income to developing world by 2015 (World Bank, Global Economic Prospects, 2001)
Possible sectors of interest to developing countries

• **Tourism**: important and fast-growing source of foreign currency for many DCs (China, Mexico, Korea, Thailand)

• **Transport services**, especially maritime services (Korea, Kuwait, Ukraine)

• **Telecommunications**: while Mexico only a major DC exporter, technological developments create market segments that DC companies can exploit

• **Computer and data processing**: the sector with the highest proportion of exports supplied by DCs (India)
Growing Interest in services in Regional Trade Agreements

RTAs in force as of February 2005
By year of entry into force (left-hand scale) and cumulative (right-hand scale)
ASEAN Trade in Services ‘90-03

[Diagram showing trends in services exports, services imports, merchandise exports, and merchandise imports from 1990 to 2003.]
Overview of WTO rules on services

• Four modes of delivery
  – Cross border supply (e.g. int'l telephone calls)– Mode 1
  – Consumption abroad (e.g., tourism)– Mode 2
  – Commercial presence (e.g., foreign bank branches)– Mode 3
  – Presence of natural persons (e.g., individuals traveling abroad to supply services)– Mode 4

• 12 service sectors
  – Professional & computer
  – Communications
  – Construction & engineering
  – Distribution
  – Education
  – Environmental
  – Financial
  – Health
  – Tourism and travel
  – Transport
  – Recreational, cultural, & sporting
  – Other n.i.e.
WTO rules on services in RTA/FTA

• Article V of GATS imposes three conditions on economic integration agreements for the latter to be deemed WTO-compatible
  – “Substantial sectoral coverage” (not the same as “substantially all sectors” as in Art. 24 of GATT)
  – Elimination of existing discriminatory measures and/or prohibition of new or more discriminatory measures (a standstill is thus sufficient)

• In both respects, GATS disciplines are weaker than those governing preferential liberalization of goods
TYPICAL NEGOTIATING MODALITIES

- Elements in Negotiating Model
- NAFTA Model
- AFAS Model
- Japan-Singapore CEP Model
Services Negotiating Models in RTA/FTA

- Elements in Negotiating Model
  - Approach to Liberalization;
  - Principle of Treatment;
  - Beneficiary
  - GATS/WTO Consistency
RTAs: Approach to liberalization

**Positive list**
(Bottom-up)
National schedules list specific commitments to provide national treatment and market access for particular service sectors and modes of supply

**Negative List**
(Top-down)
All measures and sectors considered free of restrictions unless otherwise indicated in lists of reservations - “non-conforming measures”
Positive List Approach: Pros and Cons

**Advantages**
- Used in GATS, thus familiar with members
- Gradual and progressive liberalization
- Adaptive to acceleration process
- Less resources required for administration and negotiation

**Disadvantages**
- More time needed for information exchange through request and offer exercise
- Slow pace of liberalization
- New sectors requires negotiations
- More time may be spent to define covered sectors than to find how to reform sensitive sectors
Negative List Approach: Pros and Cons

- **Advantages**
  - Comprehensive since all services sectors presumed covered
  - Greatest stimulus for competition and efficiency
  - Fast and Far-reaching liberalization
  - New sectors covered automatically

- **Disadvantages**
  - Potential risk from liberalization process
  - Administration and negotiation resources required
  - May result in greater domestic opposition due to tougher competition
NAFTA Model

• Negative Approach
• Separate chapters concerning services commitments
  – Mode 1 and 2 is under cross-border trade
  – Mode 3 is under Investment Chapter
  – Mode 4 is under Movement of Natural Person Chapter
  – Telecoms and financial services is under separate chapters
• Automatic and Universal MFN, NT applicable
NAFTA Model

Existing Regime

Cross-border Trade
Investment
Movement of Natural Persons

Negative Approach

Automatic and Universal MFN and NT

Specific Commitments
AFAS Model: Strictly GATS consistent

- Positive List Approach
- Coverage: GATS consistent no priori exclusion
- Progressive, request-offer negotiations
- No universal MFN
- Supplementary liberalization formula applicable (ASEAN-X)
AFAS Model

Existing Regime

Non-automatic or Universal MFN

Positive List Approach

GATS

Cross border supply  Commercial Presences  Movement of NP

Specific Commitments
Japan-Singapore CEP Model

- Positive List Approach in combination with Negative in line with each party’s interests and capacity

- Linkage between services and investment

- NT committed, but no universal and automatic MFN
Japan-Singapore CEP Model

Existing Regime

GATS

- Japan opted negative approach
- Singapore opted Positive approach

Investment provision

Specific Commitments
OPTIONS FOR DEVELOPING ECONOMIES
Options for developing countries

1. Positive versus Negative Approach

2. Adopt GATS rules and principles
Options for developing countries (cont.)

3. Set up linkages between services and investment by adopting provisions on non-liberalization investment rules to trade in services (Mode 3)

4. No automatic and universal MFN and NT, ensuring the momentum or dynamics for each RTA/FTA
5. Applying supplementary elements to accelerate pace of liberalization in services such as liberalization formula, setting up milestones for each stages or sectoral liberalization approaches

6. Concretize WTO/GATS rules by mutually developing definitions on beneficiaries, safeguards, reciprocity rules to consolidate a firm ground for specific commitments
Specific Measures

1. Carrying out “request and offer” excercise to identify interested sectors;

2. Emphasize on transparency requirements for negotiation

3. Harmonization of parties’ priority scope and contents
Specific Measures (cont.)

4. “Negative List Approach” should be gradually adopted in sectoral basis, where ready and applicable

5. Promoting cooperation to encourage regulatory regime, competition and investment environment for developing countries

6. Harmonization or facilitation of licensing, standards in services
Point no.1

Services issues are by far the most dominant issues on the FTA negotiating agenda

Why?
1. Trade in Services takes place in several ways

* Cross Border (eg via the internet)
* Temporary movement of customers (eg tourism, education)
* Temporary movement of service providers into the foreign market (eg foreign insurance agents, consultants)
* Setting up a local office (investment)

This complexity means it takes more than 1 Chapter of an FTA to deal with all the relevant issues
2. **The services sector includes major infra-structural industries affecting the entire economy**

- Financial services usually need to be dealt with in a separate chapter
- Telecommunications is also often dealt with in a separate chapter
- E-Commerce is often dealt with in a separate chapter
- Business mobility needs to be handled separately
3. Services account for more than 50% on average of GDP & employment (over 75% in the developed economies) & is often the major contributor to innovation & productivity growth & the fastest growing export sector.

Services industries are beginning to mobilise & to demand commercial outcomes from trade negotiations.
4. The GATS is moving too slowly.....

- And FTAs offer an opportunity for the pursuit of other “new” issues which do not figure fully on the current WTO negotiating agenda but which are closely related to Trade in Services such as E Commerce, Investment and Competition Policy

- It is inevitable that developed economies will view FTAs as potentially constructive mechanisms for addressing all of these interrelated issues
5. Reform in the Services sectors has the greatest relative power to deliver economic benefits

Most modelling work assessing the economic impact of any particular FTA will show, despite the problems of measurement, that the potential gains from liberalising services tend to outweigh the gains from liberalising trade in goods. (This is generally due to the positive impact of domestic reform in the services sector rather than due to gains from new access to trading partners’ markets.)
So there are at least 5 good reasons why an OECD country trading partner will want an FTA to focus closely and deliver results on Services related issues

Let's look at a Table of Contents....
Goods (Agriculture/Manufactured Goods/Textiles)
Tariff Schedules and Rules of Origin
Sanitary and Phytosanitary Barriers
Cross Border Trade in Services
  Positive List - Schedule of Commitments
  or Negative List Approach
    List A (Non Conforming Measures)
    List B (Sensitive Carve Outs)
Financial / Telecommunications / Professional Services
E Commerce / Other Sectors?
Mode 4 / Temporary Movement of Business Personnel
Competition Policy
Investment
Government Procurement
Intellectual Property
Standards and Technical Barriers
Dispute Settlement
Point no.2

Services issues are also proving to be the slowest and most difficult to negotiate, especially for developing countries.

Negotiators seem unprepared.
Services issues can not be avoided in any FTA negotiation with a developed economy.

It is inefficient to try to avoid them also in any FTA/RTA among less developed economies.

But the issues are complex and there are many pitfalls for developing economy negotiators.

How to get better prepared?
Steps to take

- **Step Number 1: Do your Homework.** Improve your understanding of your services sectors, including potential export interests & competitive threats. Enhance the transparency of the domestic regulatory framework.

- **Step Number 2: Get your Own House in Order.** Identify outdated & stifling red tape and get ready to implement pro-competitive regulatory reforms so that new domestic firms will be able to enter the market & allow the domestic industry to develop & grow.

- **Step 3: You are now ready to negotiate with confidence.** Steps 1 & 2 will ensure that your trade negotiating strategy is home-grown and development driven.
Your FTA partner will probably seek to remove discrimination by achieving maximum concessions on National Treatment.

(And the WTO rules on FTAs require removal of substantially all discrimination)

But remember that unless you also do Step 2 above ie pro-competitive regulatory reform (which the GATS does not insist upon), you risk transferring any existing monopoly profits to foreigners.
Food for Thought

- Remember also that any concessions you agree to make on Market Access (consistent with Step 2 above) will boost productivity and deliver net gains for economic development, including to your own domestic service providers. Remember this is in your own best interest. Take advantage, from a political perspective, of the external pressure of trade negotiations to pave the way for necessary regulatory reforms of this kind.

- The FTA negotiation provides an excellent opportunity for ongoing policy dialogue (& perhaps for receiving technical assistance) on best regulatory practices in the services sectors.
The basic concepts in a sample chapter on Cross Border Trade in Services

- A sample FTA chapter would contain principles drawn from the WTO/GATS
- But it also contains some new concepts
- Let’s focus on the aspects which are different from the GATS ie not necessarily familiar to WTO or APEC negotiators
**Important Concepts**

- Most Favoured Nation
- Denial of Benefits (rules of origin for services - generally more liberal than for goods)
- Positive List approach (like the GATS) and/or the more deeply liberalising Negative List approach (list it or liberalise it)
- 2 Schedules of Non Conforming (Sensitive) Measures
- Ratchet Mechanism
- Absence of an Emergency Safeguards clause?
Negative List Approach

Non Conforming Measures Annex 1

- Existing measures which do not conform with the principles set out in the chapter, but which are “grandfathered” in Annex 1 ie you want to retain them
- If you don’t list them in Annex 1, you are obliged to liberalise them.
- In a Federal system, it is typical to “grandfather” all existing measures at State and local level.
- No new measures which are inconsistent with the Chapter can be introduced
Negative List Approach

Non-Conforming Measures Annex 2

- List of measures with respect to which you wish to retain even greater flexibility i.e., retain the right to increase the level of protection in the future.
- These are the most domestically sensitive policy areas.
- There will always be considerable negotiating pressure to keep this list short.
Implementing services preferences

- It is worth noting that, unless the barriers to trade are quantitative in nature (eg numbers of foreign universities that can establish locally) it is probably harder, than it is for goods, to implement services sector market liberalisation on an exclusive discriminatory basis.
- Many services sector reform measures agreed in the context of a bilateral FTA could readily be multilateralised and it would generally add to the domestic economic benefit to do so.
How much services sector liberalisation is taking place via FTAs?

• In general, services liberalisation seems no easier in small groups than it is in the WTO
• Where the negative list approach is used, there have been significant WTO plus strides forward in terms of National Treatment
• Progress is less evident in terms of Market Access, at least from developed economy partners
• There is some progress on Temporary Movement of Business Persons and there are attempts underway to deal with Recognition of Professional Qualifications
• There is deeper commitment on the part of developing countries to Regulatory Transparency and there is incremental progress in the direction of regulatory harmonisation, including on telecoms and banking.
Services Liberalization by APEC Member Economies

Dr. Sherry M. Stephenson
PECC Trade Forum

APEC Workshop “Best Practices in RTAs”

Ha Noi, Vietnam, 27-28 February 2006
OBJECTIVE OF STUDY
To evaluate extent of progress in services liberalization by APEC Economics towards meeting the Bogor Goals
METHODOLOGY OF STUDY

Necessary to determine
- choice of sectors
- sources of information
- years of examination
- typology of restrictions
- modes of supply

➢ Set out in Annex I on Definitions, Sources and Methodology
CHOICE OF SERVICE SECTORS

Three sectors chosen for examination
representative sample of interest for both
developed and developing APEC economies

1. Telecommunications
2. Construction/ Related Engineering Services
3. Distribution
Four data sources chosen
to provide as complete a set of information as possible on APEC economies

1. WTO Schedules of Commitments
2. WTO Trade Policy Reviews
3. APEC Individual Action Plans
4. Annexes to Regional Trade Agreements
YEARS OF EXAMINATION

Dependent upon data source
with goal of reviewing most recent and up-to-date
information possible from various fora (multilateral and regional)

2. WTO Trade Policy Reviews – all reports between 1999 - 2005
3. APEC Individual Action Plans – all IAPS between 2001 to 2004
4. Annexes to Regional Trade Agreements – year of agreement
TYPOLOGY OF RESTRICTIONS

Adapted from WTO GATS Agreement and studies by other multilateral/ regional institutions - necessary to simplify somewhat to bring study within manageable proportions

MARKET ACCESS
4 categories

NATIONAL TREATMENT
2 categories
TYPOLOGY OF RESTRICTIONS

MARKET ACCESS
1. Restriction on foreign ownership
2. Restriction on entrance (licenses, QRs)
3. Restriction on competition
4. Restriction on type of legal entity

NATIONAL TREATMENT
1. Restriction on nationality/ residence
2. Any other type of national treatment restriction
MODES OF SERVICE SUPPLY

THREE OF FOUR MODES EXAMINED, IN TWO CATEGORIES

1. CROSS-BORDER TRADE  
   (Modes 1 and 2 under WTO GATS)
2. COMMERCIAL PRESENCE  
   (Mode 3 under WTO GATS)

➢ Note: Mode 4 not taken into consideration, as not enough information available in WTO Schedules and often excluded from RTAs
TYPOLOGY OF RESTRICTIONS

Three types of entries in order to standardize all sources of information in the tables:

- **LIBERALIZED** = no restrictions in place (green)
- **PARTIALLY LIBERALIZED** = some type of restriction in place, without judging degree of restrictiveness (yellow)
- **NOT LISTED or NO COMMITMENT** = no information provided on the sector (red)
CHALLENGES OF RESEARCH

- NATURE OF RESTRICTIONS TO SERVICES TRADE – REGULATORY MEASURES
- DIFFICULTY OF QUANTIFYING RESTRICTIVE IMPACT OF EXISTING MEASURES, ONCE IDENTIFIED
- VOLUME OF INFORMATION TO EXAMINE – 295 pages of summary tables alone
- DEVELOPING A CONSISTENT APPROACH ACROSS SOURCES IN ORDER TO BE ABLE TO COMPARE THEM
- HOW TO DEAL WITH HORIZONTAL MEASURES IN THE ANALYSIS
SUMMARY OF FINDINGS OF STUDY

➢ State of Liberalization of APEC Economies in the Services Area far from Bogor Goals

GENERAL CONCLUSIONS

THERE IS STILL A GREAT DEAL TO BE DONE; SERVICES LIBERALIZATION IS FAR FROM ACHIEVED IN APEC; MANY RESTRICTIONS REMAIN; INFORMATION FOR COMPREHENSIVE ASSESSMENT IS INCOMPLETE; RTAs HAVE GONE MUCH FURTHER
I. EXAMINING WTO SERVICES COMMITMENTS BY APEC ECONOMIES

Summary of Existing Restrictions on Services as set out in Schedules of Commitments for 18 APEC Economies – WTO Members

1. Telecommunications
2. Construction /Related Engineering Services
3. Distribution
**Telecommunications Services (1)**

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- Green: Liberalized
- Yellow: Partially Liberalized
- Red: No Commitment / Not listed
- X: Detailed information available in Table 3
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*x* Detailed information available in Table 6
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Detailed information available in Table 9
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**Legend:**
- **Liberalized**
- **Partially Liberalized**
- **No Commitment / Not listed**
- **Detailed information available in Table 9**
Comments on GATS Commitments

- More commitments in telecom sector than any other, and more recent; EVEN SO

1. Sectoral and modal coverage uneven by APEC Members
2. Information incomplete - several missing commitments
3. Liberalization incomplete:
   27% of telecom sector liberalized;
   16% construction sector liberalized;
   26% distribution sector liberalized
II. EXAMINING WTO TRADE POLICY REVIEWS FOR APEC ECONOMIES

Summary of Information available in WTO Trade Policy Reviews between 1999-2005 for 17 APEC Economies

1. Information on Telecom Sector for 17 Economies
2. Information on Construction/Engineering for 2 Economies
3. Information on Distribution for 1 Economy
## Telecommunications Services (1)

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- **Liberalized**: Green
- **Partially Liberalized**: Yellow
- **No Commitment / Not listed**: Red
- **Detailed information available in table 19**: Crossed-out
Comments on Trade Policy Reviews

- Studies are infrequent; only one review per APEC economy (other than PNG, Peru and United States) for past six years

1. Minor part of TPRs devoted to services – no in-depth coverage
2. Information only available for telecom but not for construction/engineering or distribution
3. Description of measures are very general; difficult to make coincide with other sources
4. Telecom liberalization incomplete:
   19% of telecom sector liberalized
III. EXAMINING APEC INDIVIDUAL ACTION PLANS (IAPs)

Summary of Information available in APEC Individual Action Plans between 2000/2001 and 2004 or most recent year for 18 APEC Economies

1. Information on Telecom Sector for 18 Economies
2. Information on Construction/Engineering for 16 Economies
3. Information on Distribution for 18 Economies
# Telecommunications Services

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*Detailed information available in Table 12*
### Construction and Related Engineering Services

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*Legend:*
- **Liberalized**
- **Partially Liberalized**
- **Not Listed**

× Detailed information available in Table 14
## Distribution Services

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- **Green**: Liberalized
- **Red**: Partially Liberalized
- **Not listed**: Detailed information available in Table 16
Comments on APEC IAPs

- Available in electronic form since 2000 but four APEC Economies have not submitted any IAPs

1. Gaps in IAP coverage for years and sectors
2. No information provided on cross-border trade (modes 1 and 2); only on commercial presence (mode 3)
3. Comparison with other sources difficult as description of measures is very general – no classification numbers
4. Information not updated every year; little changes between 2000 and 2004 in majority of IAPs that tend to repeat WTO GATS commitments

4. Liberalization incomplete:
   - 18% of telecom sector liberalized;
   - 13% construction sector liberalized;
   - 14% distribution sector liberalized
IV. EXAMINING REGIONAL TRADE AGREEMENTS (RTAs)

Summary of Information available in Annexes to Regional Trade Agreements (RTAs) among APEC Member Economies

Restrictions on Services as set out in the Lists of Non-Conforming Measures (i.e. those measures that do not comply with the core disciplines of the agreement, namely to liberalize MFN, national treatment, market access, cross-border supply)
11 REGIONAL TRADE AGREEMENTS
examined involving APEC ECONOMIES

RTAs adopting a “negative list” approach examined
- ANZCERTA : Australia-New Zealand 1989 – 1999 annex
- NAFTA: Canada-Mexico-USA 1994
- FTA: Canada – Chile 1997
- FTA: Chile – Mexico 1999
- CEP: New Zealand – Singapore 2001
- FTA: USA – Chile 2004
- FTA: USA – Singapore 2004
- FTA: Korea- Chile 2004
- FTA: USA – Australia 2005
- EPA: Japan – Mexico 2005
- EPA: Brunei-Chile-NZ-Singapore 2006
## Telecommunications Services: Without Horizontal Reservations

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* Trans-Pacific Strategic Economic Partnership Agreement among Brunei Darussalam, Chile, New Zealand and Singapore
## Construction and Related Engineering Services: Without Horizontal Reservations

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*Trans-Pacific Strategic Economic Partnership Agreement among Brunei Darussalam, Chile, New Zealand and Singapore*
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* Trans-Pacific Strategic Economic Partnership Agreement among Brunei Darussalam, Chile, New Zealand and Singapore
## Telecommunications Services: With Horizontal Reservations

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¹ Trans-Pacific Strategic Economic Partnership Agreement among Brunei Darussalam, Chile, New Zealand and Singapore

Note: Detailed information available in Table 23.
## Construction and Related Engineering Services: With Horizontal Reservations

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<thead>
<tr>
<th>Schedule</th>
<th>Cross-Border</th>
<th>Commercial Presence</th>
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<td>Australia - New Zealand</td>
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<td>New Zealand - Singapore</td>
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<td>Schedule of United States</td>
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<td>Schedule of Korea, Rep. of - Chile</td>
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<td>Schedule of Australia</td>
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<td>Schedule of Japan</td>
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<td>Japan - Mexico</td>
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<td>Schedule of Trans-Pacific SEP¹</td>
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<td>New Zealand</td>
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<td>Trans-Pacific SEP¹</td>
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<td>Trans-Pacific SEP¹</td>
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¹ Trans-Pacific Strategic Economic Partnership Agreement among Brunei Darussalam, Chile, New Zealand and Singapore
**Distribution Services: With Horizontal Reservations**

<table>
<thead>
<tr>
<th>Schedule of Country</th>
<th>Cross-Border</th>
<th>Commercial Presence</th>
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<tbody>
<tr>
<td>Australia - New Zealand</td>
<td>Distribution Services</td>
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<tr>
<td>New Zealand - Singapore</td>
<td>Wholesale Trade Services</td>
<td>Franchising</td>
</tr>
<tr>
<td>Chile - Mexico</td>
<td>Distribution Services</td>
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<tr>
<td>United States - Chile</td>
<td>Distribution Services</td>
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<td>United States - Singapore</td>
<td>Distribution Services</td>
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<td>Korea, Rep. of - Chile</td>
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<td>Chile - Mexico</td>
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<tr>
<td>Trans-Pacific SEP¹</td>
<td>Distribution Services</td>
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</tr>
</tbody>
</table>

¹ Trans-Pacific Strategic Economic Partnership Agreement among Brunei Darussalam, Chile, New Zealand and Singapore
Comments on APEC RTAs

- Annexes of most RTAs examined quite recent

1. RTAs under the “negative list” approach require comprehensive sectoral coverage as well as complete information on all outstanding restrictions (or “non-conforming measures”)

2. These RTAs thus provide greater transparency and greater information than other service agreements

3. Two types of non-conforming measures: sector-specific and horizontal; difficulty is in dealing with the horizontal measures, to determine their impact.

4. Liberalization under RTAs has gone further than under WTO or APEC IAPs but is still incomplete.
Services Liberalization under RTAs

- Taking into account Horizontal Measures:
  - TELECOM  33 % telecom sector liberalized
  - CONSTRUCTION/ ENG  45 % sector liberalized
  - DISTRIBUTION  40 % distribution sector liberalized

- With only Sectoral Measures:
  - TELECOM  64 % telecom sector liberalized
  - CONSTRUCTION/ ENG  88 % construction sector liberalized
  - DISTRIBUTION  84 % distribution sector liberalized

**NOTE: IN BOTH CASES, LIBERALIZATION MORE ADVANCED**
WHERE HAS SERVICES LIBERALIZATION GONE FURTHER – in APEC?

- Have any APEC Members gone beyond WTO GATS commitments in their APEC IAPs?

TELECOM: One economy has gone further (Singapore); but 5 economies have provided more information in WTO context (Korea, Malaysia, New Zealand, Chinese Taipei, United States).

CONSTRUCTION/ENGINEERING SERVICES: Three economies have gone further (Chile; Peru; Singapore) but 5 economies have provided more information/liberalization in WTO context (Canada, Japan, Chinese Taipei, Thailand, United States).

DISTRIBUTION SERVICES: Five economies have provided more information in APEC IAPs (Chile, Indonesia, Malaysia, Mexico, Philippines), but 7 economies have provided more information/liberalization in WTO context (Australia, PRChina, Japan, Korea, Chinese Taipei, Thailand, United States).
WHERE HAS SERVICES LIBERALIZATION GONE FURTHER – in RTAs?

- Have any APEC Members gone beyond WTO liberalization in their RTAs?

  TELECOM: Yes – members of 7 RTAs have gone further in liberalization

  CONSTRUCTION/ENGINEERING SERVICES: Yes – members of 7 RTAs have gone further in liberalization

  DISTRIBUTION SERVICES: Yes – members of 8 RTAs have gone further in liberalization
Conclusions

- Services liberalization in APEC still has a long ways to go.
- APEC Members are not close to meeting the Bogor Goals.
- Information provided on services liberalization in the APEC context is often not as complete as that in the WTO or in RTAs.
- The regional forum or RTAS have produced greater liberalization of services to date by APEC Members through “negative list” RTAs; however membership of these RTAs is limited and there is no obligation to extend this treatment to other economies.
INVESTMENT

APEC Workshop on FTAs
Hanoi February/March 2006
Jane Drake-Brockman
Investment does not (yet?) fully figure on the WTO negotiating agenda

- Most OECD economies have relatively open foreign investment regimes and offensive investment interests in developing economies.
- Developing economies, despite their obvious and overwhelming economic interests in attracting foreign investment, typically operate more restrictive regimes.
- So it is inevitable that developed economies will see FTAs as potentially useful mechanisms for addressing bilateral investment irritants.
- Developing countries need to be ready to discuss ways of covering investment issues in FTAs and to respond to demands from bilateral partners to make investment related commitments that go “beyond the WTO.”
Remember

A potential bilateral offer of investment liberalisation is very valuable negotiating coin – it may be enough to bring a reluctant major trading partner to the negotiating table...........
In a globalising world economy, the interactive relationship between Investment and Trade is extremely complex & evolving. Trade Negotiators need to understand this better.
Trade and Investment?
-Goods-

- In protected goods sectors, inward flows of foreign direct investment can act a **SUBSTITUTE** for trade. Foreigners are motivated to invest overseas in order to get around tariff barriers in the host country by servicing the host market from inside. “Pre-establishment” barriers to investment limit this option.

- Foreign investment also acts as a **COMPLEMENT** to trade

  --Investment may be focused on exploiting comparative advantages in the host economy, boosting bilateral or global **EXPORT** from the host economy
  
  --Investment also seems to stimulates **EXPORT** growth from the home economy, of both goods and services, including via intra-industry trade
Trade and Investment -Services-

- When their domestic clients invest offshore, services providers try to follow those domestic clients abroad. Often they require a commercial presence in the offshore market to service those customers effectively, so they also invest. **If the policy regime is sufficiently open, foreign investment in goods can breed foreign investment in services.**

- Services providers look for foreign clients in their own right - & to service them effectively, they need to pursue their own offensive investment interests to achieving **commercial presence** in that market.

- As services activities which traditionally have been government-owned & operated enter the realm of the private market place, they also become attractive to the international market. **Foreign participation in these activities requires inward direct investment.**
Although we don’t fully understand it yet, we do know that the relationship between Trade and Investment is increasingly seamless…………….but

- Investment policy tends to be in the realm of Finance Ministries, Treasuries and Investment Authorities
- The idea of investment negotiations, in any forum, is still a bit of a mystery to trade negotiators – and trade negotiations, in any forum, still remain a bit of mystery to Finance Departments and Treasury officials
- Disciplines on Investment have proved elusive to date in the multilateral fora, including the OECD

So how should we handle Investment in FTAs?
There is more than one way to draft an FTA chapter on Investment

- All of them are potentially confusing for private sector investors!
- The US approach is gaining in ascendency?
- Typically, the Investment Chapter will aim to cover investment in both goods sectors & services sectors.
- Typically, the Investment Chapter will aim to pull together into 1 chapter
  --the key elements of the usually pre-existing Bilateral Investment Protection and Promotion Agreement
  --along with reaffirmation of various relevant WTO disciplines (eg TRIPS)
  --plus commit, where possible, to more liberal conditions for market entry &
  --extend National Treatment post-establishment
  --commit perhaps to a “minimum standard of treatment”?
Defining Investment

- Investment means every asset that an investor owns or controls, directly or indirectly, involving eg the commitment of capital or other resources, the expectation of gain or profit or the assumption of risk.
- FDI (involving direct participation by the investor in the management of the investment)
- Portfolio Investment (minority holding of shares, bonds or other securities)
Treatment of Investors and their Investments

- Pre-Establishment Disciplines
- Post-Establishment Disciplines
- Non Discrimination
  --National Treatment
  --Most-Favoured-Nation Treatment
- Minimum Standard of Treatment
- Performance Requirements
- Transfers and Payments
- Expropriation & Compensation
- Senior Personnel
Scheduling Commitments

- **Horizontal Commitments**
  - foreign investment approval mechanisms
  - land purchases
  - foreign exchange regulations
  - eligibility for government subsidies
- **Sectoral Schedules of Non Conforming Measures (Negative List?)**
- **Sectoral Schedules of Reserved Sectors (Negative List?)**
- **Combined Schedules (Negative Lists) of both Services and Investment Commitments**
Non Conforming Measures
A schedule containing a list of all those measures that are not fully in conformity with the liberalising provisions of the Agreement

Reserved Sectors (Sensitive Carve Outs)
A schedule listing the sectors in which future “policy space” is preserved ie in which the parties may unilaterally introduce policy changes without contravening the provisions of the Agreement.

Dispute Settlement
Benefits to developing economies of negotiating a deal on Investment

In addition to all the other important “non-trade” public policy objectives you may be seeking to preserve, remember that the overriding objective in negotiating an Investment Chapter in an RTA/FTA, should be to send a positive and welcoming message to (desperately needed) private sector foreign investors.
Implementing Investment Liberalisation

- Whatever one thinks about the bilateral preferential approach to trade, there is much less question that a discriminatory approach to investment liberalisation makes no economic sense.

- Wherever possible, pre-establishment investment liberalisation which is negotiated bilaterally should be implemented multilaterally as soon as possible.
Labour Movement and International Trade

WTO, FTAs and Bilateral Labour Market Access Agreements
Why does this matter?

- A New Bilateralism is emerging that is outside of WTO context.
  - Bilateral Access Agreements
  - FTAs covering visas
  - Broader bilateral approaches to commodities
- Temporary Movement and migration are very important sources of forex earning for many APEC economies
- Aging OECD populations mean that labour movement issues will become more important over the next 25 years
Is Migration Covered by WTO?

- Scholars agree that permanent movement is clearly outside the WTO. Temporary movement arrangements can be seen as either inside or outside.
- WTO Secretariat has issued papers that interpret labour movement as not being a mode 4 issue.
- If it is time bound and sector specific it is more likely to be subject to WTO. Are temporary workers in the tourism sector covered by GATS but those in agriculture, not covered?
- Many WTO members including USA, EU and Canada have listed various bilateral labour market schemes in their MFN exemption schedule.
At the end of the Uruguay Round WTO members agreed to exempt their WTO violations - it was not intended to be indefinite.

‘In principle’ these should continue for 10 years i.e. 2005 and in any case there should be negotiations i.e. built-in agenda.

As we know from MFA 10 years always comes too quickly.

Has been reviewed twice and members disagree about the future of MFN exemptions.
OECD countries maintain 180 such agreements and the number is rising.

Many advanced ‘developing’ countries e.g. Korea, Malaysia, South Africa and the Gulf states import labour and have such agreements with source countries.

These are often negotiated by immigration and foreign affairs officials with no trade officials participating.

These are temporary, sector specific and often quota based.
Examples of BLMAA

- **Canada Seasonal Agricultural Worker Scheme**
  - Extends to 13 countries – Mexico and 12 Caribbean countries for 17,000 workers per season
  - Scheduled as an ‘indefinite’ MFN exemption in Canada’s schedule
  - Considered as ‘state of the art’ labour agreement
  - Mexican provisions could be brought under NAFTA, Caribbean market access needs new arrangement
Examples of BLMAA

- US Seasonal Agricultural Scheme (H-2A) Visa (Bilateral or Multilateral?)
  - USA issued 28,000 H-2A visas in 2001, 79% were for Mexicans and 13% for Jamaicans
  - US scheme is not based on quotas and is open to all WTO members, in theory. As a result, unlike the Canadian scheme it requires no MFN exemption
  - In practice the US requires the employer to cover the cost repatriation of the employee and therefore only proximate sources of supply are commercial
  - Unless challenged the US scheme is WTO compatible
  - Bush administration wants to create a ‘humane guest worker scheme’
EU BLMAA Schemes

- The EU situation is quite different from that of US and Canada because of the supply from EU acceding countries to the east.
- GATS Article V and Vbis often apply for BLMAA with East European and Euro-Med agreements.
- Some are of questionable WTO compatibility e.g. Italy-Nigeria, Italy–Sri Lanka etc.
- The extent of the MFN violation has often increased following 1995 without notification or seeking waivers.
Are BLMAA’s WTO Compatible?

If they are listed as an MFN exemption and a panel considers 10 years to be the length of time they were expected to exist then ‘no’

They require waivers if they are to be expanded.

If no agreement in the current round Panel may have to rule on MFN exemptions of ‘indefinite’ duration
FTA’s and Labour Movement Issues

- US and EU FTAs have labour market access provisions.
- US has attempted to extend visa and labour market issues until the US-Chile and US-Singapore FTAs.
- US congress carved out 6,400 visas allocated in these FTAs from MFN quota of ‘up to’ 65,000 H-1B visas provided under GATS. This is of questionable WTO compatibility.
- Who could challenge- most H-1B visas are allocated to Indian and Chinese nationals.
- Since Singapore –US and Chile –US there have been no bold migration measures in US FTAs.
FTAs and Labour Market Access

- The most recent FTA between Japan and Philippines (not yet implemented) has important provisions for nurse mobility.
- It is understood that there are differences over whether there should be numerical quotas.
- Japan-Philippines is potentially a new generation of agreements.
- Some WTO issues over whether it is possible to impose numerical quotas on service suppliers.
How do we make FTAs and BLMAAs WTO compatible

- Economic Integration Agreements (GATS Article V)
- Labour Market Integration (Article Vbis)
- Negotiated solution on MFN exemptions (unlikely)
- Waivers for on-going MFN violations
The Future

- Labour market access issues will become more important as OECD and Chinese population ages.
- Will need to address this either bilaterally through FTAs or multilaterally.
- Multilateralism will yield largest returns for developing countries eg nurses in bilateral approaches
- A dispute on migration at the WTO should be avoided at all cost.
Labor Standards in the US and EU Preferential Trading Arrangements

Veniana Qalo
Commonwealth Secretariat
Outline of Presentation

A. Introduction
B. Labor Standards
C. US-FTAs
D. EU-Association Agreements & FTAs
E. Non-Reciprocal Preferential Arrangements
F. Conclusions
Why this paper?

- Stalemate at WTO bypassed through gradually escalating obligation on trade related labor standards in bilateral and non-reciprocal trade agreement.
A. Introduction

- 1970s (Tokyo Round) and 1980s (Uruguay Round) – US push for inclusion of GATT Article on labor standards

- 1996 (Singapore Ministerial) – with support from France, southern EU members, Canada and Japan, US continued pursuance on inclusion of trade-labor issue in WTO.

- Singapore Declaration however mandated referral of trade-labor discussions to ILO
‘Predictably hardest to resolve was the issue of labour standards, where the US threatened to veto the entire declaration if no mention was made. Ministers eventually agreed to uphold internationally recognised core labor standards...but trade sanctions to enforce them were rejected and there is no provision for follow up work with the WTO, which is asked simply to maintain its (minimal) collaboration with ILO.’

[FT, Dec 16, 1996]
Effects of Labor Standards

- **Proponents:** enforcement of labor standards through trade agreements improves working conditions and wages of workers in poor countries, thereby reducing wage differentials between rich and poor countries.

- **Opposition:** Efforts to bring labor standards into multilateral trade negotiations were seen as smokescreen for protectionism or bid by developed industrial nations to undermine comparative advantage of lower wage trading partners.
Option for Dispute resolution at the WTO on breach of trade-related labor standards Obligations
- ASCM
- Article XX
B. Labor Standards

Labor Standards in WTO Law

(i) GATT Article XX

- ‘adoption of measures necessary for enforcement of public morals’ (XX.a)
- ‘protection of human life or health’ (XX.b)
- ‘products of prison labor’ (XX.e).

**Shrimp-Turtle Case:** Article XX can be used as a basis for WTO sanctions in cases involving gross violation of labor rights.
(ii) Agreement on Subsidies and Countervailing Measures (ASCM)

- Export Incentives to firms in Export Processing Zones i.e. derogation from national social security and taxation provisions - Prohibited Subsidies (ASCM, Annex I (e));
## Core Labor Standards and ‘Others’

<table>
<thead>
<tr>
<th>ILO Convention</th>
<th>US FTAs</th>
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<tr>
<td>(i) guarantee of right to organise and bargain collectively;</td>
<td>(i) Right to organise and bargain collectively;</td>
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<tr>
<td>(ii) prohibition of forced labour;</td>
<td>(ii) Prohibition on the use of any form of forced or compulsory labor</td>
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<tr>
<td>(iii) prohibition of child labour; and</td>
<td>(iii) Minimum age for employment of children;</td>
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<td>(iv) elimination of discrimination against different categories of workers on the basis of gender, ethnicity etc.</td>
<td>(iv) Right of Association; and</td>
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<td>(v) Acceptable conditions of work with respect to minimum wages, hours of work, and occupational safety and health</td>
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C. US FTAs

- North American Free Trade Agreement (NAFTA)
- US-Jordan FTA
- US-Singapore FTA
- US-Chile FTA
- US-Australia FTA
- Central American FTA (CAFTA)
- US-Morocco FTA
North American Free Trade Agreement (NAFTA)

- **11 labor principles** in NAFTA side-agreement (NAALC) i.e. ILO principles + ‘minimum standards such as minimum wages and overtime pay..’

- Must be incorporated in domestic labor laws, harmonized and continually improved.

- Only breach of trade-related labor standards can be brought to dispute settlement mechanism under NAFTA

- **Remedies**: imposition of fines, enforcement action, suspension of NAFTA benefits based on amount of fine.
US-Jordan FTA (2001)

- Labor standards shifted to main provisions of agreement.
- Defines ‘internationally recognised labor rights’ as ILO standards + ‘acceptable conditions of work with respect to minimum wages, hours of work.’ but excludes ‘elimination of discrimination on the basis of gender, ethnicity etc’.
- Parties required to prescribe minimum wage limit in domestic legislation.
- Derogation in order to encourage trade results in breach and possible recourse to dispute settlement mechanism under FTA.

- Trade related labor provisions of agreements substantially similar to US-Jordan FTA
- Sanctions are authorized only for sustained or recurring failure to enforce one’s labor laws in a manner affecting trade between the Parties.
- If Party fails to implement agreed solution, imposition of fine of up to US$15mil and suspension of benefits imposed for failure to pay.

- ILO + ‘internationally recognised labor rights’ protected in domestic laws
- Parties aren’t allowed to derogate from these in order to encourage trade or investment
- Sanctions are authorized only for sustained or recurring failure to enforce one’s labor laws in a manner affecting trade between the Parties

- Only trade-related labor rights can be brought under the dispute resolution process.
- Parties have option of referring trade-related labor disputes arising under the agreement to the WTO – a process not similarly articulated in US-Singapore, US-Chile nor US-Jordan FTA.

<table>
<thead>
<tr>
<th>ILO standards + 'internationally recognised labor rights'</th>
<th>Sanctions are authorized only for sustained or recurring failure to enforce one's labor laws in a manner affecting trade between the Parties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Must be implemented in domestic labor laws</td>
<td>Only trade-related labor issues can be brought to dispute settlement</td>
</tr>
<tr>
<td>Parties aren’t allowed to derogate from these</td>
<td>Parties have option of referring trade-related labor disputes arising under the agreement to the WTO</td>
</tr>
<tr>
<td>in order to encourage trade or investment</td>
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</table>

- ILO standards + ‘internationally recognised labor rights’
- Must be implemented in domestic labor laws
- Parties aren’t allowed to derogate from these in order to encourage trade or investment
- Sanctions are authorized only for sustained or recurring failure to enforce one’s labor laws in a manner affecting trade between the Parties
- Only trade-related labor issues can be brought to dispute settlement
- Parties have option of referring trade-related labor disputes arising under the agreement to the WTO
US-CAFTA

- ILO + ‘internationally recognised labor rights’ to be incorporated in domestic labor laws.
- Parties aren’t allowed to derogate from these in order to encourage trade or investment.
- Sanctions are authorized only for sustained or recurring failure to enforce one’s labor laws in a manner affecting trade between the Parties.
- Parties have option of referring trade-related labor disputes arising under the agreement to the WTO DSB.
Emerging Trend

- US FTAs mandatory requirement for inclusion of trade-related labor rights in Partie’s domestic legislation, including establishment of minimum wage limit for workers;
- Requirement for non-derogation from such principles in domestic legislation in order to encourage trade or investment from other non-Parties.
- Creates a perception that the US is aiming to achieve on labor standards, through WTO panel ruling, what is not achievable by political consensus at the WTO.
Rationale for US stance

- Private Sector Advisory Committee system introduced by US Congress in 1974 – influential in US trade policy formulation including advice on position re. trade agreements.

- Labor Advisory Committee (LAC) – appointed and managed by USTR

- Powerful & Highly organized labor, import-competing firms and public interest groups proponents of stricter labor standards applied to low-income countries.
D. EU Association Agreements & FTAs

- Euro-Med Agreements
- Europe Agreements
- EC-Chile FTA
- EC Trade, Development and Cooperation Agreement with South Africa (TDCA)
Despite EU’s internal commitment to labor standards, there is no attempt to negotiate such standards into FTAs, even with countries which have already negotiated these standards with the US i.e. Chile, Mexico.

**Assumption:** Labor standards in NAALC and US-Chile must be applicable on MFN basis to EU as well so no need for EU to introduce such standards in its bilateral FTAs.
E. Non-Reciprocal Preferential Trading Arrangements

- US GSP Schemes
- EU GSP Schemes
- Cotonou Agreement
F. CONCLUSIONS

- It is possible to view these kinds of bilateral and non-reciprocal preferential agreements as a TROJAN HORSE, a precedent setting means of introducing new issues into the WTO negotiating process.

- The ability to do anything about this might grow progressively weaker as key negotiating allies in developing countries agree to bilateral engagement with US and EU.
Reconsideration of position taken at Singapore required and development of rules limiting proliferation and escalation of ad hoc labor standards through FTAs and preferentials.
THE TREATMENT OF AGRICULTURE IN REGIONAL TRADE AGREEMENTS

APEC Workshop “Best Practices in RTAs”

Ha Noi, Vietnam, 27-28 February 2006

Dr. SHERRY STEPHENSON
DIRECTOR, a.i.
Department of Trade, Tourism and Competitiveness
MAIN PROVISIONS ON AGRICULTURE IN RECENT RTAs

**US – Chile**
- Agricultural export subsidies
- Agricultural safeguard measures
- Agricultural marketing & grading standards
- Working Group on Agricultural Trade
- Mutual Recognition for Grading of Beef

**US – DR - CAFTA**
- Agricultural export subsidies
- Agricultural safeguard measures
- Administration of tariff rate quotas
- Sugar compensation mechanism
- Consultations on trade in chicken
- Agriculture Review Commission
- Committee on Agricultural Trade
Export Subsidies

Subsidized exports between the FTA parties banned BUT export subsidies may be reintroduced to counter subsidized competition from non-FTA parties.

Forms of export subsidies not specified

Provision never been tested

Domestic Support – US-DR-CAFTA

There are no commitments on domestic support in FTAs.
For this, quantities must exceed or prices must be below a fixed trigger level.

Provision has not been used.

DR-CA lists more U.S. goods as eligible for agricultural safeguard measures than the U.S. has listed goods from these countries.
Tariff elimination on agricultural products over time with a slower pace by developing partner(s):

- Some back-loading
- Many tariff rate quotas and special safeguards
Duty Free Entry

98% of (the value of) imported goods (including agriculture) originating from DR-CAFTA will enter the U.S. duty-free immediately on entry into force of the agreement (22% already enter free)

Tariff Elimination by CAFTA

Agricultural goods imported into DR-CAFTA and originating from the U.S.:

- Agricultural tariffs to be eliminated on a product and country-specific basis:
  - Immediate
  - 5 years
  - 10 years
  - 12-20 years (5-10 year grace period for US chicken leg quarters, rice and certain dairy products)
US-DR-CAFTA Agreement

Exclusions for the U.S.:

The out-of-quota tariff on sugar will not be eliminated by the U.S. BUT, the U.S. did offer increased quotas for the DR-Central American parties on sugar but allowed the U.S. to give alternative forms of compensation rather than take the imports.

Exclusions for Central America:

Exclusions from tariff elimination for the following US exports:
- Potatoes and onions for Costa Rica
- White corn for other Central American signatories

Many tariff-rate quotas and special safeguards
The U.S. provides the same tariff treatment to each of the six other parties, but makes country-specific commitments on tariff rate quotas.

For a few agricultural goods subject to tariff rate quotas, while the in-quota rate is duty-free, the U.S. will eliminate the out-of-quota tariffs from DR-CAFTA as follows:

- Beef: 15 years
- Peanuts: 15 years (6-year grace period)
- Peanut Butter: 15 years
- Dairy Products: 20 years (10-year grace period)
Tariffs on goods, including agricultural products, will be eliminated within 12 years by both parties.

Exclusions:
No product exclusions in the agreement (all agricultural tariffs to be liberalized).
US-Chile Agreement

Duty Free Entry for Chilean exports

On the U.S. side, 85% of (the value of) imported goods originating from Chile entered the U.S. duty-free immediately on entry into force of the agreement (54% already entered free).

Duty Free Entry for U.S. exports

On the Chilean side, 87% of (the value of) imported goods originating from the U.S. entered Chile duty-free immediately on entry into force of the agreement.
**US-Chile Agreement**

**Tariff Elimination by the U.S.**

- 62 tariff lines are subject to the longest (12-year) staging period for elimination.

- The U.S. also back-loads its (12-year) tariff elimination staging for wine products from Chile.

**Tariff Elimination by Chile**

- 109 tariff lines are subject to the longest (12-year) period for elimination.
Tariff Rate Quotas for Chile applied by U.S.

Some agricultural goods from Chile are subject to tariff rate quotas and to tariff elimination periods for out-of-quota tariffs lasting up to 12 years (and back-loaded).

<table>
<thead>
<tr>
<th>Product</th>
<th>Time Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beef</td>
<td>4 years</td>
</tr>
<tr>
<td>Dairy Products</td>
<td>12 years (7-year grace period)</td>
</tr>
<tr>
<td>Sugar</td>
<td>12 years</td>
</tr>
<tr>
<td>Tobacco</td>
<td>12 years</td>
</tr>
<tr>
<td>Avocados</td>
<td>12 years (4-year grace period)</td>
</tr>
<tr>
<td>Processed artichokes</td>
<td>12 years</td>
</tr>
<tr>
<td>Poultry</td>
<td>10 years (2-year grace period)</td>
</tr>
</tbody>
</table>
**Tariff Rate Quotas for U.S. applied by Chile**

Chile applies tariff rate quotas on certain meat products originating from the U.S. and is eliminating out-of-quota tariffs on these goods as follows:

- **Beef**: 4 years (with an initial access quantity of 1,000 metric tons)
- **Chicken & Turkey**: 10 years (2-year grace period with no initial access quantity)
DIFFERENCES BETWEEN WTO AND RTAs

- Same product coverage but different objectives and disciplines.

- RTAs are more ambitious on market access but less so on domestic subsidies, export subsidies, export credits and food aid.
WTO Agreement on Agriculture

“...Objective is to establish a fair and market-oriented agricultural trading system and that a reform process should be initiated through the negotiation of commitments on support and protection and through the establishment of strengthened and more operationally effective FTAA rules and disciplines...[and] to provide for substantial progressive reductions in agricultural support and protection sustained over an agreed period of time, resulting in correcting and preventing restrictions and distortions in world agricultural markets.”

Art. 20: “the long-term objective of substantial progressive reductions in support and protection resulting in fundamental reform is an ongoing process.”
WTO Doha Round Goals

Comprehensive negotiations aimed at:

- Substantial improvements in market access (tariff reductions)
- Reductions of, with a view to phasing out, all forms of export subsidies
- Substantial reduction in trade-distorting domestic support
Outcome of WTO Hong Kong Ministerial

- Date certain (2013) set for elimination of all agricultural export subsidies; some in-kind food aid, export credits and STE practices to be disciplined.

- Trade-distorting subsidies: Countries to be categorized into three bands, with highest to be cut the most.

- Tariffs: Countries to be categorized into four bands, with highest to be cut the most.

- Development: LDCs to get tariff- and quota-free access to high income country markets for 97% of tariff lines plus more aid for trade capacity building.

- Deadlines for remaining work:
  - Modalities by 30 April 2006
  - Tariff schedules by 31 July 2006
FTAA Objectives
(San José Ministerial Declaration:

- Progressively eliminate tariffs and non-tariff barriers, as well as other measures with equivalent effects, which restrict trade between participating countries;

- Eliminate agricultural export subsidies affecting trade in the Hemisphere; and

- Identify other trade-distorting practices for agricultural products, including those that have an effect equivalent to agriculture export subsidies, and bring them under greater discipline.
RTAs and WTO Consistency

- Under the WTO, an RTA must be notified and reviewed for WTO-consistency (GATT Art. XXIV and GATS Art. V).

- To qualify as an exception to the MFN principle under GATT Art. XXIV (and the Understanding on its interpretation), an interim agreement leading to a free trade area must:
  - eliminate duties on “substantially all the trade” in goods between its members within a reasonable length of time; i.e., not exceeding ten years.

- In practice, the WTO has a backlog of RTAs to review; none has ever been disapproved of by the (GATT or) WTO membership thanks to the consensus rule.

**QUESTION:**

What would be the potential welfare gains from full trade liberalization and agricultural reform, by country/region, due to:

- developed relative to developing countries’ policies?
- agriculture relative to manufacturing policies?
- within agriculture, tariffs relative to export subsidies and domestic support?
World Bank model’s gain by 2015 from removing current protection policies

Global benefit from removing current tariffs on all goods plus agricultural subsidies would be $287 billion per year by 2015

- Would have been about $350 billion if reforms during 2001-2004 also included

2/3rds accrues to high-income countries

But as % of GDP, the benefit to developing countries as a group is twice that for developed countries.
### Full liberalization: global gain ($bn)

<table>
<thead>
<tr>
<th>$ billion due to reform by:</th>
<th>Agric &amp; food</th>
<th>Textiles clothing</th>
<th>Other manuf</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>High-income countries</td>
<td>135</td>
<td>15</td>
<td>9</td>
<td>159 (55%)</td>
</tr>
<tr>
<td>Developing countries</td>
<td>47</td>
<td>23</td>
<td>58</td>
<td>128 (45%)</td>
</tr>
<tr>
<td>All countries’ policies</td>
<td>182 (62%)</td>
<td>38 (14%)</td>
<td>67 (24%)</td>
<td>287 (100%)</td>
</tr>
</tbody>
</table>
### Full liberalization: gains to developing countries

<table>
<thead>
<tr>
<th>$billion due to reform by:</th>
<th>Agric &amp; food</th>
<th>Textiles &amp; clothing</th>
<th>Other manuf.</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>High-income countries</td>
<td>26</td>
<td>13</td>
<td>4</td>
<td>43    (50%)</td>
</tr>
<tr>
<td>Developing countries</td>
<td>28</td>
<td>9</td>
<td>6</td>
<td>43    (50%)</td>
</tr>
<tr>
<td>All countries’ policies</td>
<td>54 (63%)</td>
<td>22 (27%)</td>
<td>10 (10%)</td>
<td>86    (100%)</td>
</tr>
</tbody>
</table>
# Importance of 3 agricultural pillars

<table>
<thead>
<tr>
<th>Welfare gains from:</th>
<th>Agric market access</th>
<th>Agric domestic support</th>
<th>Agric export subsidies</th>
<th>All agric policies</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of gain to:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Developing countries</td>
<td>106</td>
<td>2</td>
<td>-8</td>
<td>100%</td>
</tr>
<tr>
<td>World</td>
<td>93</td>
<td>5</td>
<td>2</td>
<td>100%</td>
</tr>
</tbody>
</table>
Agricultural & food output rise from full lib’n
(percentage change from baseline income in 2015)
Take-away messages from full lib’n

- Potential gains from further trade reform are **large**
  - must find the political will for Doha success
- **DCs would gain disproportionately** from reform, notwithstanding non-reciprocal tariff preferences
- But DCs would gain as much from South-South as South-North trade growth
  - importance of DC reform too
- **Agricultural reforms are the highest priority** for goods, from global and developing country welfare viewpoints
Take-away messages from full lib’n (cont.)

- Removal of agric export subsidies: great achievement
- Reducing/disciplining other trade-distorting agric domestic support is crucial too
- But gains to DCs from agric subsidy cuts could be multiplied many-fold by also cutting agric tariffs
  - with half coming from South-South trade growth
- Adding non-agric market access has the potential to raise the welfare gains to DCs by >50%, and help balance the North-South exchange of ‘concessions’
Lessons and Experiences of Mexico in dealing with issues emerging from RTAs/FTAs participation

APEC Workshop on Best Practices in Trade Policy for RTAs/FTAs: Practical Lessons and Experiences for Developing Economies

February-March, 2006
Rationale to Negotiate a FTA

Policy Goals

- Increase the level of production, employment and investment
- Improve market access for goods and/or services in the international market
- Attract foreign direct investment
Mexico’s Trade Negotiations

BILATERAL
- FTAs
- BITs
- RTAs

MULTILATERAL
Mexico’s network of FTAs

- 12 FTAs
- 20 BITs
- 7 RTAs
Successful stories

- Mexico is the eight most important trading economy worldwide and the first one in Latin America.
- In 13 years exports have quadrupled the level they had in 1993 (51.9 millions of US dollars).
Successful stories

Exports have become a very important source of economic growth:

✓ During 1994-2000 GDP growth was due to exports in more than 50% percent

✓ On third of new jobs was related to exporting activities
Successful stories

- Between 1993 and 2004 imports growth was 201.8%

- During 1994-2003 Mexico was the fourth most important destination of foreign direct investment (FDI) among developing economies and the first one in Latin America.
Successful stories

FDI has led to technology transfer, new jobs and increased wages in high-added value sectors such as automotive, electronic and electric industries.
Successful stories

In 2004, Mexico-US trade tripled pre-NAFTA levels

Growth 04/93 211%

US imports from Mexico  Mexican imports from the US
Successful stories

With NAFTA, trade between Mexico and Canada increased sharply

- Growth 04/93: 288%

- Billion of US Dollars

<table>
<thead>
<tr>
<th>Year</th>
<th>Canada imports from Mexico</th>
<th>Mexican imports from Canada</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>1995</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>1997</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td>1999</td>
<td>10</td>
<td>7</td>
</tr>
<tr>
<td>2001</td>
<td>12</td>
<td>10</td>
</tr>
<tr>
<td>2003</td>
<td>16</td>
<td>12</td>
</tr>
</tbody>
</table>
Trade with other FTA partners has also increased ...

- Costa Rica (1995) 659%
- Bolivia (1995) 156%
- Colombia (G-3, 1995) 129%
- Nicaragua (Jul. 1998) 106%
- Chile (1992) 707%
- Venezuela (G-3, 1995) 121%
Key actions to implement FTAs

- Make dispositions established in FTAs operative
- Managing FTAs
Key actions to implement FTAs

Make dispositions established in FTAs operative

- Certificate of Origin
- Customs procedures
- Rules of origin
- Tariff reduction
- Quota provisions
In order to make a FTA operative, Mexico publishes in the official gazette:

- A set of rules to inform all interested parties the customs formalities that have to be followed in order to apply the preferential tariff treatment to imported goods;
Key actions to implement FTAs

• The template of the certificate of origin (auto-certification) or the certification rules (certification by authority);

• The preferential tariff duties that will be applied during a specific time frame thus they could be known by customs authority and economic operators;
Key actions to implement FTAs

• Application forms and procedures that allow access to quotas established in FTAs by interested parties;

• Procedures to apply for refund of duties paid in excess (where applicable); and
Key actions to implement FTAs

• Requirements governing applications for advance rulings.
Publication in the official gazette requires coordination among several authorities
Key actions to implement FTAs

Example: (preferential tariff duties)

Regulatory Improvement Commission
(Regulatory Impact Assessment)

Ministry of Economy
(technical area, legal counselor, etc.)

Ministry of Treasure
(revenue office, etc.)

Presidencia
(State Department)

Official Gazette
Managing FTAs

✓ Meetings of Committees/Subcommittees as established in FTAs

✓ Exchange/update contact points
Key actions to implement FTAs

✓ Follow up the implementation of FTAs with the feedback of the business sector

✓ Exchange information about quota utilization
FTAs/RTAs shall grant flexibility in the procedures required for its implementation
This is particularly true with regard to administrative actions related to the practices and logistic of international trade.
DIFFICULTIES

Example:
Some dispositions of the Movement Certificate EUR.1 under the EU-Mexico FTA constitute impractical requirements that obstruct trade
DIFFICULTIES

Movement certificate EUR.1 requirements:

Each form shall measure 210 x 297 cm; a tolerance of up to 5 minus or plus 8 mm in the length may be allowed.

The paper used must be white, sized for writing, not containing mechanical pulp and weighting not less than 25 g/m2.
It shall have a printed green guilloche pattern background making any falsification by mechanical or chemical means apparent to the eye.

Any alteration must be initiated by the person who completed the certificate and endorsed by the customs authorities …
DIFFICULTIES

Nature of the problem

• Each EU Customs Office makes use of different kinds of paper which do not conform to specifications established in the FTA

• EU Customs authorities are not used to apply the FTA dispositions regarding fulfillment of the certificate of origin
DIFFICULTIES

Outcome

• Non compliance of the EU certification authorities lead Mexican Customs to reject the certificates of origin

• Trade flows slowed down and economic operators faced additional costs
Solution

• Mexico and the EU had to negotiate interpretation notes to resolve operative problems related to the information that has to be placed in the certificate and the technical reasons to reject a certificate
Final Remarks

- Negotiation of FTAs/RTAs demands legal and institutional infrastructure
- Participation of industry representatives, academia, trade unions and other public/private organizations and civil society is key factor in the negotiating process
Final Remarks

- Involvement of interested parties in the negotiation entails flexible mechanisms of consultation.
- Implementation of FTAs/RTAs requires a roadmap to coordinate actions of government authorities.
Final Remarks

- FTAs/RTAs are useful trade policy instruments in order to achieve higher levels of production, investment and employment.
- Flexible operation of FTAs/RTAs is cornerstone to avoid administrative obstacles to trade.
VIETNAM’S PARTICIPATION IN ASEAN FREE TRADE AREA:
Lessons and Experiences
Structure of presentation

I. Asean Free Trade Agreement (AFTA)

II. Vietnam’s Integration to AFTA

III. Lessons and Experiences
ASEAN FREE TRADE AGREEMENT (AFTA) AND BEYOND
ASEAN FREE TRADE AREA (AFTA)

- Trade in Goods (Agreement on the Common Effective Preferential Tariff Scheme for the ASEAN Free Trade Area – CEPT/AFTA), 28 Jan 1992

- Trade in Services (Asean Framework Agreement on Services – AFAS), 15 Dec 1995

- Investment (Framework Agreement on ASEAN Investment Area – AIA), 7 Oct 1998

- Sectoral cooperation in agriculture, industry, mineral, tourism, transports,...
CEPT/AFTA: Agreements

Common Effective Preferential Tariff Scheme for the ASEAN Free Trade Area (CEPT/AFTA), 28 Jan. 1992

Protocol to Amend Agreement on CEPT Scheme for the ASEAN Free Trade Area, 15 Dec 1995

Protocol on the Special Arrangement for Sensitive and Highly Sensitive Products, 30 Sept. 1999

Protocol Regarding the Implementation of the CEPT Scheme Temporary Exclusion List, 23 Nov 2000

And other Protocols on notification, cooperation
CEPT/AFTA: Basic provisions

1. Coverage

2. Tariff reduction and NTB elimination

3. Preferential Eligibility (Rules of Origin, Reciprocity)

4. Emergencies measures
CEPT/AFTA: Basic provisions (Cont.)

1. Coverage:

- Article 3 of CEPT Agreement (Dec 92): “all products, including capital goods, processed agricultural products, and those products failing outside the definition of agricultural products. Agricultural products shall be excluded from CEPT Scheme”.

- Article 2 of Protocol to Amend CEPT Agreement (Dec 95): “This (CEPT) Agreement shall apply to all manufactured products, including capital goods and agricultural products”

- General Exemptions (Article 9 of CEPT Agreement): in consistence with GATT (Articles XX and XXI) (i.e: to protect national security, public moral, human and animal health, artistic, historic and archaeological value)

- Thus, consistent with GATT (Article XXIV) regulation for “substantially all trade”.

CEPT/AFTA: Basic provisions (Cont.)

2. Tariff Reduction (Art 4 of CEPT Agreement) and NTB elimination (Art 5)

- **Inclusion Lists (IL)** subject to tariff reduction with final goals of rates between 0-5% within 10 years

- **Temporary Exclusion List (TEL)**: subject to delay reduction and obligation to phase-into IL.

- **Highly Sensitive List (HSL)**: further delayed reduction with ultimate target rate of less than 20%.

- **General Exclusion List (GEL)**: WTO-consistent items and others subject to phase-out review, starting 2006.

- **NTB eliminated** upon enjoyment of CEPT concessions
CEPT/AFTA: Basic provisions (Cont.)

Deadlines for AFTA tariff reduction

<table>
<thead>
<tr>
<th>Members Countries</th>
<th>Tariff Rates</th>
<th>0-5%</th>
<th>0%</th>
<th>Limited latest shift</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASEAN-6</td>
<td>2002</td>
<td>2010</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vietnam</td>
<td>2006</td>
<td>2015</td>
<td></td>
<td>2018</td>
</tr>
<tr>
<td>Laos – Myanmar</td>
<td>2008</td>
<td>2015</td>
<td></td>
<td>2018</td>
</tr>
<tr>
<td>Cambodia</td>
<td>2010</td>
<td>2015</td>
<td></td>
<td>2018</td>
</tr>
</tbody>
</table>
CEPT/AFTA: Basic provisions (Cont.)

3. Preferential Eligibility (Rules of Origin, Reciprocity)

- CEPT tariff rates not more than 20%

- Appear in Inclusion List of both exporting and importing countries

- Originating in ASEAN
CEPT/AFTA: Basic provisions (Cont.)

CEPT Rules of Origin

- Regional Value Content not less than 40%
- Partial cummulation of not less than 20% allowed
- Introduction of CTC rule (textile, aluminum, wheat powder,...)
CEPT/AFTA: Basic provisions (Cont.)

4. Emergencies Measures

- Article 6 of CEPT Agreement allows suspension of preferences provisionally, without discrimination and GATT consistent to prevent or to remedy injury caused by import of CEPT eligible products.
Beyond AFTA:

ASEAN Economic Community 2020

1. Accelerated Intra-regional Economic Integration
   - Trade in goods (CEPT/AFTA)
   - Trade in services (AFAS)
   - Investment (AIA)
   - Priority Sectors (textile and apparel, fisheries, agro-based products, automobiles, wood-based products, rubber-based products, electronics, tourism, e-ASEAN, health-care, air-travel)
   - Other sectoral cooperation (industry, customs, energy, mining...)
   - Mechanism reform (Enhanced DSM, ASEAN Charter,...)

2. Economic Integration with Dialogue partners
   - On-going and prospective negotiations to establish FTA/CEP
   - Economic cooperation with other partners (Canada, Pakistan, Russia Federation, United States)
## ESTIMATED TIMELINES OF FTA/CEP NEGOTIATIONS

<table>
<thead>
<tr>
<th>Agreement</th>
<th>China</th>
<th>ROK</th>
<th>Japan</th>
<th>India</th>
<th>Aus. &amp; NZ</th>
</tr>
</thead>
<tbody>
<tr>
<td>Framework Agreement/Summit Declaration</td>
<td>⚙️</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Agreement on trade in goods</td>
<td>✓</td>
<td>✓ */</td>
<td>2006</td>
<td>2006</td>
<td>2007</td>
</tr>
<tr>
<td>Agreement on trade in services</td>
<td>2006</td>
<td>2006</td>
<td>2007</td>
<td>2007</td>
<td>2007</td>
</tr>
</tbody>
</table>
## CEPT/AFTA versus FTA/CEP

<table>
<thead>
<tr>
<th></th>
<th>CEPT</th>
<th>AC FTA</th>
<th>AK FTA</th>
<th>AI FTA</th>
<th>AJ CEP</th>
<th>AANZ FTA</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASEAN-6</td>
<td>2010</td>
<td>2010</td>
<td>2010</td>
<td>2012</td>
<td>2012</td>
<td>*</td>
</tr>
<tr>
<td>Vietnam</td>
<td>2015/18</td>
<td>2015</td>
<td>2016</td>
<td>2017</td>
<td>2017</td>
<td>*</td>
</tr>
<tr>
<td>CLM</td>
<td>2015/18</td>
<td>2015</td>
<td>2018</td>
<td>2017</td>
<td>2017</td>
<td>*</td>
</tr>
</tbody>
</table>

*: Subject to negotiation
VIETNAM’S PARTICIPATION IN CEPT/AFTA
VIETNAM’S PARTICIPATION IN CEPT/AFTA

Basic obligations

- **Inclusion List**: 0-5% by 2006

- **Temporary Exclusion List**: final transfer by 2003, current suspension of 14 lines of automobiles and motorcycle and parts thereof.

- **Highly Sensitive List (HSL)**: phase-in from 2004 with final goals of tariff between 0-5% by 2010 for sugar, by 2013 for rice, citrus fruits, eggs, bovine animals. Limited latest shift until 2018.

- **General Exclusion List**: Phasing-out review starts 2006.
VIETNAM’S PARTICIPATION IN CEPT/AFTA (Cont)

Phases of CEPT implementations

- 1996-1998
- 1999-2002
- 2003-2006
**VIETNAM’S PARTICIPATION IN CEPT/AFTA (Cont)**

**Period 1996-1998:**

- Small portion of products liberalized (26.4% of total tariff nomenclature)
- First commercially meaningful products only from 1998 (vegetable, coffee, tea, textile) mostly for export benefit.
- Limited increasing in trade value (3 bil increase in import, almost unchanged export)
- Weak public awareness.
- Generally, no major impact reported
VIETNAM’S PARTICIPATION IN CEPT/AFTA (Cont)

Period 1999-2002

- First transfer of TEL into IL in 1999

- Increasing number of tariff lines of rates higher 5% => substantial reduction

- Commercially meaningful with rapid increase in C/O Form D applicants

- First 5-year schedules issued in 2001
VIETNAM’S PARTICIPATION IN CEPT/AFTA (Cont)

Period 2003-2005

- Speed-up liberalisation
- Last transfer of TEL into IL (with suspension)
- Around 97-98% of tariff lines having rates of 0-5%, only limited number of lines remained in HSL, TEL
- Record increase in trade value
- Substantially accomplish CEPT/AFTA obligation
### VIETNAM’S PARTICIPATION IN CEPT/AFTA (Cont)

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>No of lines in IL</strong></td>
<td>875</td>
<td>1551</td>
<td>1719</td>
<td>3608</td>
<td>4273</td>
<td>4996</td>
<td>5549</td>
<td>10144</td>
<td>10143</td>
<td>10277</td>
</tr>
<tr>
<td><strong>No of lines 0-5%</strong></td>
<td>875</td>
<td>1166</td>
<td>1209</td>
<td>2505</td>
<td>2991</td>
<td>3228</td>
<td>3607</td>
<td>7213</td>
<td>7495</td>
<td>8496</td>
</tr>
<tr>
<td><strong>Percentage</strong></td>
<td>1</td>
<td>75.1</td>
<td>70.3</td>
<td>69.9</td>
<td>70.0</td>
<td>64.6</td>
<td>65</td>
<td>71.1</td>
<td>73.8</td>
<td>82.6</td>
</tr>
<tr>
<td><strong>No of lines of &gt; 5%</strong></td>
<td>0</td>
<td>385</td>
<td>510</td>
<td>1103</td>
<td>1282</td>
<td>1768</td>
<td>1942</td>
<td>2931</td>
<td>2648</td>
<td>1781</td>
</tr>
<tr>
<td><strong>Percentage</strong></td>
<td>0</td>
<td>25</td>
<td>30</td>
<td>31</td>
<td>30</td>
<td>35</td>
<td>35</td>
<td>29</td>
<td>26</td>
<td>17</td>
</tr>
</tbody>
</table>
VIETNAM’S PARTICIPATION IN CEPT/AFTA (Cont)

Distribution of tariff bands in IL, 96-05
VIETNAM’S PARTICIPATION IN CEPT/AFTA (Cont)

Distribution of tariff bands in IL, 96-05

- Percentage of lines 0-5%
- Percentage of line >5%
VIETNAM’S PARTICIPATION IN CEPT/AFTA (Cont.)

ASEAN Integration Scheme of Preferences (AISP): unilateral preferences for CLMV from ASEAN-6

- Preferences granted to Vietnam:
  - Indonesia: 71 tariff lines
  - Malaysia: 170 lines
  - Philippines: 15 lines
  - Thái Lan: 63 lines
  - *Singapore: already duty-free.
VIETNAM’S PARTICIPATION IN CEPT/AFTA (Cont.)

Total trade (imports & exports) with ASEAN

[Graph showing the total trade value (in $ billion) with ASEAN from 1995 to 2004, with separate lines for exports, imports, and total. The trade value increases over time, indicating growth in trade with ASEAN.]
VIETNAM’S PARTICIPATION IN CEPT/AFTA (Cont.)

Export Destinations in ASEAN, 96-04

Year

Percentage (%)
VIETNAM’S PARTICIPATION IN CEPT/AFTA (Cont.)

Import Sources from ASEAN, 96-04
VIETNAM’S PARTICIPATION IN CEPT/AFTA (Cont)

Utilization rate of CEPT preferences

Number of Form D application

Value of Form D utilisation (mil. USD)

Percentage of export to ASEAN (%)
VIETNAM’S PARTICIPATION IN CEPT/AFTA (Cont.)

Upside:
- Progressive and proactive liberalization, in line with over strategy of Renovation.
- Encouraging results (trade, investment, diversified products, policy, public awareness, no sudden shock)

Downside:
- Relatively unchanged in portion of ASEAN trade in total trade (20-22%), but understandable
- Continuous trade deficit
Free Trade and Customs Union Agreements. Experience of the Russian Federation

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THE CIS FREE TRADE AGREEMENT
of 15 april, 1994

- The agreement is made between Azerbaijan, Armenia, Belarus, Georgia, Moldova, Kazakhstan, the Russian Federation, Ukraine, Uzbekistan, Tajikistan and the Kyrgyz Republic.

- The Agreement creates a free-trade area within the meaning of Article XXIV:8(b) of GATT 1994. It provides for the elimination of customs duties, taxes and charges which are of equivalent effect, and quantitative restrictions on substantially all the trade between the Parties.

- Products covered by the Agreement are goods originating from the customs territory of a Contracting Party and intended for the customs territory of other Contracting Parties.
AGREEMENT ON FOUNDATION OF EURASIAN ECONOMIC COMMUNITY (EAEC) Of October 2000

➢ The agreement is made between: Belarus, Kazakhstan, the Kyrgyz Republic, the Russian Federation, and Tajikistan.

➢ The EAEC is established for the purpose of efficient promotion of the process of formation by Parties of the Customs Union and the Common Economic Zone.

➢ The Agreements concluded under the auspices of the EAEC are aimed at fostering economic cooperation between entities of counties-members, unification of foreign trade, customs policies and trade remedies, cooperation between the financial and banking systems, cooperation in social and humanitarian areas, and cooperation in the field of legal regulation.
AGREEMENT ON CREATION OF A UNIFIED STATE
Of December 1999

- The agreement is made between The Russian Federation and the Republic of Belarus
- The purpose of the Agreement is, inter alia, the establishment of a common economic area and the setting of a legal basis for a common market for free trade in goods and services, free movement of capital and labor
PARTNERSHIP AND COOPERATION AGREEMENT

(THE PCA)

of June 1994

- The agreement is made between The Russian Federation and the EU.

- The main objectives of the PCA are: to provide an appropriate framework for political dialogue, to promote trade and investment and harmonious economic relations, to strengthen political and economic freedoms, to provide a basis for economic, social, financial and cultural cooperation and to provide an appropriate framework for the further integration between the Russian Federation and a wider area of cooperation in Europe.

- All goods, which are imported from the territory of one Party to the territory of another Party, are exempted from the interstate taxes and duties in addition to those, which are applied to the national goods.