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

By

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Executive Summary

World trade is increasingly being dominated by preferential trade agreements that have taken precedence over multilateral trade negotiations. Within Asia and the Pacific an explosion of bilateral deals is taking place that seems likely to produce a tangle of hub-spoke trade blocs centered on major Asian or Pacific countries. While many of the emerging free trade agreements appear to be consistent with Article XXIV of GATT and Article V of GATS in principle, the complex and idiosyncratic rules of origin in these agreements threatens to complicate international commerce and to divert trade rather than creating it. Rules of origin are a necessity to determine which products will enjoy reduced bilateral tariffs and which will not and to prevent trans-shipment of goods through the customs territory in a bloc with the lowest tariff.

Exceptions to the fundamental WTO principle of most favored nation (MFN) treatment are allowed as well under the Enabling Clause for trade preferences amongst developing countries (particularly for non-reciprocal preferences extended by more developed countries to less developed countries such as GSP) with very few requirements. Unfortunately, restrictive rules of origin enforce strict limits on the volume of trade subject to preferences limiting the value of such non-reciprocal preference programs. Preferential trade agreements amongst developing countries (e.g., AFTA) have vague rules and high administrative costs that (along with small margins of preference) deter business from seeking to take advantage of preferences, thus limiting the amount of trade these agreements create.

A review of newly emerging FTAs involving key Asian hubs (Japan, Rep. of Korea, PRC, Singapore and Thailand) reveals that rules of origin not only differ between hubs but also within them. Rules of origin have been framed with the interests of industrial lobbies in mind rather than with trade facilitation as the goal. Value added rules or "regional content requirements" range from 30-70 per cent in these agreements. Detailed rules of origin even limit the amount of types of yarn or fabric that can be used in producing clothing in determining eligibility for tariff preferences. Spoke countries that enter into agreement with hubs may find that their exporters will shift purchases of intermediate goods away from the lowest cost suppliers in order to comply with rules of origin in gaining preferential access to the hub. As a result their products may become less competitive in third country markets and efficient existing production networks may be displaced by less efficient ones that thrive on tariff discrimination rather than on low production costs. As a result, spoke countries may trade less with one another and more with large hubs, defeating the intention of promoting trade and development. Of particular concern is that hub-spoke systems may disrupt development of efficient regional production networks within Asia by providing more favorable treatment to preferential suppliers outside the region than to Asian partners. For example, Rep. of Korea maintains tariffs on textiles and garments produced in Singapore over a 5-10 year phase out under the Singapore-Korea FTA yet the Chile-Korea FTA provides duty free entry to textiles and garments from Chile immediately.

Tariff discrimination is most serious in cases where MFN tariffs remain high and where tariff escalation (higher tariffs on processed products compared with raw materials)

are in place. In industries of strong interest to developing countries in Asia—clothing, intermediate textile products and footwear, tariff discrimination in the US market is in double-digits. That is, non-preferential Asian suppliers are at a cost disadvantage ranging from 10 to 20 per cent compared with preferential suppliers (and domestic producers) in the US market. This may lead more Asian countries to seek bilateral deals and may also lead to less Asian interest in multilateral trade negotiations. Indeed, research reveals that countries that join PTAs are less likely to reduce MFN tariffs on products that receive preferential tariff treatment. This encourages closed as opposed to open regional blocs.

The volume of trade covered by preferential arrangements is rising but more developed countries are better able to partake of preferential treatment than less developed and small countries. This is true of non-reciprocal PTAs such as GSP or special preference programs that the US and EU have created to help less or least developed countries as well as for full-blown reciprocal Free Trade Agreements. For example, Canada ships over three-quarters of its products to the US under NAFTA, compared with about 60 per cent for Mexico and 55 per cent for Chile. India, Thailand and Indonesia are able to avail of GSP for 13-25 per cent of their shipments to the US, but Nepal and Maldives can barely avail of GSP at all.

What can be done? Previous experience with WTO efforts to harmonize non-preferential rules of origin is instructive—it can't be done in anyone's lifetime. Hence, instead of an overly ambitious harmonization work program some more realistic proposals need to be entertained. These include introduction of flexibility into rules of origin so firms can choose how to comply, allowing cummulation within hub-spoke systems of free trade agreements, lowering value-added content rules for less developed countries or allowing averaging over a period of time in compliance with such rules, and putting some teeth into enforcement of Article XXIV and Article V requirements. These interim steps could limit damage to multilateral trade until a more comprehensive agreement on preferential rules of origin is put in place.

Introduction

The prospects for completion of the Doha Development Round prior to the lapse of Trade Promotion Authority (TPA) in the United States took a turn for the worse with a formal cessation of negotiations in late July of 2006 (The Economist, July 29th 2006: 67-68). One of the immediate consequences is that bilateral free trade agreements will be given priority and will continue to mushroom, particularly in the Asia-Pacific Region. A mapping of free trade agreements involving at least one Asian or Pacific Developing Country (Asian Development Bank, *Asian Development Outlook 2006)* reveals that 36 such agreements had been notified to the World Trade Organization as of March 2006 and that a further 43 agreements had entered into force but were not yet notified and active negotiations had been launched involving another 43 such agreements. In addition, there are many other bilateral deals on the drawing board (under study). The WTO also reports that globally 197 Preferential Trade Agreements (PTAs) have been formally notified by member countries and that such agreements may well cover around half of total world merchandise trade.[1]

There are reasons to be concerned about the proliferation of bilateral trade agreements, especially in the absence of a new WTO Round. As long as the Doha negotiations were active, optimists regarding preferential trade agreements could argue that such agreements would have but a mild effect in terms of trade diversion resulting from discriminatory tariff treatment in such deals. With a global tariff-cutting formula covering manufactures (by far the bulk of global merchandize trade) and with a similar agreement to reduce agricultural tariffs, once the multilateral liberalization kicked in, margins of preference would be sharply eroded in PTAs. In addition, investment flows would remain relatively undistorted as investors would take into account longer-term prospects for more open global trade. However, without a Doha Round of multilateral liberalization, dark clouds on the horizon may mean stormy times lie ahead for world trade. First, the US may push ahead in attempting to close and sign bilateral deals between now and June 2007 with major partners like Rep. of Korea and Malaysia and these deals may be less benign than if negotiated with an active Doha Round in progress. Second, developing countries disappointed by the Doha Round's apparent demise may legitimately pursue cases against the US and EU in the WTO over illegal farm subsidies and other practices and this may create a less positive atmosphere for restarting negotiations. Third, both developed and developing countries may be tempted into using antidumping measures (and other contingent forms of protection such as safeguards or countervailing duty measures) should the global economy slow down, further burdening the system and creating more animosity among members.

In this report the main concern going forward is with particular aspects of the Preferential Trade Agreements—the *Rules of Origin*. Rules of origin are essential components of PTAs in order to prevent trade deflection and enforce tariff discrimination (James 2005). In the absence of such rules, individual members of PTAs would lose tariff policy autonomy, as trade would flow through the member with the lower or lowest *most favored nation (MFN)* tariff and would undercut revenue collection in the members with

[1] The actual volume and value of trade that utilizes preferential tariffs is not known with any precision, however. This report attempts to provide some evidence on this point in the case of U.S. preference programs involving developing countries for which accurate data are available (see Section VI below). The 197 PTAs cited above refers to those notified and still in force as perhaps another 100 PTAs that had been notified to the GATT/WTO are defunct.

higher MFN tariffs (Panagariya 2001). It is also important to recognize that governments regard rules of origin as not simply a technical device to enforce preferential trade agreements, but view such rules as vital commercial policy instruments (Vermulst and Waer 1990; James 2005).

The failure of the contracting members of the WTO to complete the negotiations aimed at harmonization of *non-preferential rules of origin* as provided for in the Uruguay Round Agreement (GATT 1994) on Rules of Origin is an indication not only of the technical complexity of rules of origin but also reflects the members' desire to retain autonomy in setting product-specific rules of origin in order to protect their industries. The refusal of contracting members to agree to even negotiate harmonization of preferential rules of origin confirms the reservation of such rules as commercial policy tools, indeed as tools of protection of special interests and "sensitive" products.

In this report, section III examines the requirements of the WTO for notification of PTAs and the information this conveys, particularly with regard to the nature of a PTA. Section IV provides a review of newer Asia-Pacific PTAs and their rules of origin, including a systematic exploration of differences between rules of origin regimes followed by specific hub countries—Japan, Rep. of Korea, PRC, Singapore and Thailand. Section V then provides some estimates of how PTA tariff discrimination may affect Asian-Pacific developing countries in key industries using US trade and tariff data. Section VI examines PTA utilization rates in the US case by groups of developing countries receiving preferential tariff treatment and attempts to correlate these with different rules of origin. Finally, Section VII concludes with some proposals for discipline over preferential rules of origin.

WTO Requirements for Preferential Trade Agreements

The central principle established by the General Agreement on Tariffs and Trade (GATT) in Article I of GATT 1947 is that of non-discrimination or what is referred to as MFN (Most-Favored-Nation Treatment). As expressed by Trebilcock and Howse (1999: 27):

> "Under Article I of the GATT, with respect to customs duties or charges of any kind imposed by any country on any other member country, any advantage, favor, privilege, or immunity granted by such country to any product originating in any other country shall be accorded immediately and unconditionally to a like product originating in the territories of all other Members."

Exceptions to Article I are allowed under GATT Article XXIV: Territorial Application—Frontier Traffic—Customs Unions and Free-trade Areas; under the Enabling Clause: Differential and more favorable treatment reciprocity and fuller participation of developing countries (established by decision of contracting members on 28 November 1979 during the Tokyo Round); and under the General Agreement on Trade in Services (GATS) Article V:

Economic Integration as part of the Uruguay Round Agreement (GATT 1994).[2] Each of these three routes of escape from Article I of GATT have requirements of varying degrees and it is these requirements that may cause the choice of escape route to convey useful information about the nature of a PTA.

Specifically, Article XXIV requires notification of customs unions and free trade areas to the WTO; that such agreements cover substantially all (merchandise) trade; that products excepted from such agreements be phased into the agreement within a "reasonable length of time" (usually considered to be at most ten years); and forbids such agreements from increasing restrictions on the commerce of non-members relative to the barriers existing prior to the formation of the PTA. Article XXIV also proscribes contracting members to take reasonable measures to ensure that sub-national levels of government and authorities within its territories observe the terms of any such agreements.

Since 1994, many free trade agreements include some coverage of services in addition to goods and such agreements must include notification under Article V of GATS in addition to Article XXIV. The requirements of Article V include notification of such agreements to the WTO Council for Trade in Services; substantial coverage of services sectors; elimination of discriminatory measures among the members of the agreement; and proscribes such agreements from raising the overall level of barriers in services to non-members compared to the pre-existing situation (prior to conclusion of the PTA).

The Enabling Clause provides for non-reciprocal preferences such as those under the Generalized System of Preferences (GSP) that are granted developing countries by developed countries as well as providing for special more favorable treatment for least developed countries within any agreements. The Enabling Clause aims at encouraging developing countries among the contracting members to enter into regional arrangements aimed at mutual reduction of tariffs or elimination of non-tariff measures on products imported from one another. Requirements are lighter than under GATT Article XXIV: notification of agreements to the WTO including consultation with any contracting member with regard to any difficulty that may arise from such arrangements. The Clause specifies that developed countries do not expect reciprocation by developing countries but also that such arrangements create no impediment to elimination of tariffs or other restrictions on trade on an MFN basis.

The choice of notifying PTAs under the enabling clause as opposed to GATT Article XXIV is available to any reciprocal agreement involving two or more developing country partners. Such a notification usually conveys the information that there are substantial product exemptions in the agreement and that "sensitive products" are likely to be excluded altogether. Furthermore, the rules and institutional arrangements for the implementation of such light agreements may be presumed to be weak or ill-defined. In the area of rules of origin, PTAs are often vague compared with agreements notified under Article XXIV. Margins of preference are also frequently much more limited than under full-blown free trade

[2]Exceptions to Article I are explained, see for example: Trebilcock and Howse (1999:27-28). The full texts of these articles and agreements can be downloaded from the homepage of the WTO: http://www.wto.org/

agreements, implying that such agreements may have far less actual impact on trade flows (whether in terms of trade creation or of trade diversion).

Non-reciprocal agreements between developed and developing and least developed countries are potentially of more consequence than reciprocal agreements among developing countries because of the size of the market and improvement in market access implied. However, the ability of developing countries to take advantage of non-reciprocal agreements may also be a function of the degree of generosity implicit in the rules of origin as will be seen below.

Proliferation of PTAs in Asia and the Pacific and Rules of Origin

The former Director-General of the WTO, Supachai Panitchpakdi, in mid-2003 commissioned a study entitled *The Future of the WTO: Addressing institutional challenges in the new millennium* (The Consultative Board, 2004, hereafter referred to as "The Sutherland Report"). The study was chaired by Peter Sutherland and was written by the Chairman and seven other eminent trade experts. The Sutherland Report (The Consultative Board, 2004: 19) makes the following observation in the 2nd Chapter *The Erosion of Non-Discrimination:*

> "The choice of unconditional MFN as the defining principle of the GATT reflected widespread disillusionment with the growth of protectionism and especially of bilateral arrangements during the inter-war period. . . . key political leaders as well as most students of trade concluded that MFN, and its attendant non-discrimination, was the best way to organize international trade . . . Yet nearly five decades after the founding of the GATT, MFN is no longer the rule; it is almost the exception. Certainly, much trade between major economies is conducted on an MFN basis. However, what has been termed the "spaghetti bowl" of customs unions, common markets, regional and bilateral free trade areas, preferences and an endless assortment of miscellaneous trade deals has almost reached the point where MFN treatment is exceptional treatment. Certainly the term might now better be defined as LFN, Least-Favored-Nation treatment."

The Sutherland Report held out the hope that the WTO could eventually reduce MFN tariffs to zero as a means of mitigating the potentially harmful effect of the proliferation of PTAs, yet this hope has been dashed by the collapse of the Doha Round. A second line of defense against the burgeoning PTAs identified in the Sutherland Report (p. 26) is through a "clarification of Article XXIV and a better-organized means of administering its provisions." This is a polite way of stating that it is high time to begin serious enforcement of the requirements of Article XXIV (and similarly, Article V of GATS).
However, it is less clear whether or not this line of defense could be activated without a successful conclusion to the Doha Round.[3]

[3] Immediately before the collapse of the Doha Round, Director-General Pascal Lamy (10 July 2006) welcomed a new WTO agreement on regional trade agreements (RTAs) aimed at improving transparency and consistency of RTAs with GATT Article XXIV and GATS Article V. This agreement was meant to be part of the rules

Recent advances in modeling Preferential Trade Agreements have shown that membership in PTAs makes member countries less willing to liberalize MFN tariffs on the subset of goods that a country imports under a PTA (called PTA goods) than for non-PTA goods and empirically verifies this result in the case of the United States' membership in the North American Free Trade Agreement (NAFTA) and other preference programs (including ATPA, CBI, and GSP).[4] The MFN tariffs worldwide on PTA goods may remain higher than otherwise and worldwide PTAs may make countries less willing to engage in multilateral trade liberalization (MTL). It is important to recognize that if this effect can be confirmed empirically it implies that PTAs violate the requirement that any PTA (waiving Article I) must not constitute an impediment to lowering tariffs on an MFN basis, as is pointed out in Lumao (2006: 912).

As is shown in the quotation above, the Sutherland Report (p.19) identifies the "spaghetti bowl" effect of the proliferation of PTAs and even criticizes restrictive rules of origin in PTAs such as the Generalized System of Preferences (p. 25). However the Sutherland Report stops short of directly commenting on the issue of preferential rules of origin or of suggesting that such rules of origin be brought under WTO/GATT disciplines. One reason is perhaps the difficulties that have been experienced in the long-stalled attempt to harmonize and further discipline non-preferential rules of origin.[5] And it is also true that contracting members have vetoed previous efforts to compose a working group on preferential rules of origin and were content with a non-binding statement on preferential rules of origin in GATT 1994 (the Uruguay Round Agreement).

The WTO provides detailed information on recently notified PTAs on its homepage. Agreements notified under Article XXIV and Article V (GATS) provide much more detailed information than those notified under the Enabling Clause. The recent agreements involving at least one UNESCAP member country were examined and details of agreements, including chapters covering rules of origin and detailed annexes containing product-specific rules of origin were obtained for free trade agreements involving Asian-Pacific "hub countries" defined to include Japan, the Rep. of Korea, the PRC, Thailand and Singapore. At least two agreements involving each hub could be obtained in detail and these serve as the basis for tables summarizing rules of origin provisions in each agreement. The focus for purposes of this study was to examine rules of origin in manufactured products where rules of origin are more important and complex than for agricultural products and raw materials where the "wholly obtained" criterion is sufficient to confer origin. For manufactured goods, rules of origin may be of three basic types: i) a change in tariff heading (CTH Rule) defined at the six-digit Harmonized System level; ii) a value-added (VA Rule) usually defined as a minimum percentage of regional value content necessary to confer origin or by a maximum amount of non-originating content allowed in order to confer origin; and iii) a specified process (SP Rule) defined as manufacturing operations that must be undertaken in order to

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component of the Doha Round Agreement, arrived at by the Negotiating Group on Rules. See the WTO homepage: http://www.wto.org/english/news_e/rta_july06_e.htm

[4] See Lumao (2006)

[5] See James (2005) and Imagawa and Vermulst (2005) for detailed accounts of the negotiations over non-preferential rules of origin.

confer origin. It is noteworthy that CTH and VA or SP rules are frequently combined in rules of origin in PTAs despite the general preference of using a CTH rule in the Uruguay Round Agreement on Rules of Origin.[6]

The purpose for this study of examining in detail rules of origin in recent Asian-Pacific PTAs is to determine the internal consistency of rules of origin within each "hub" and between hubs as well. The internal consistency of rules of origin would simplify matters should spoke countries in a hub (e.g., Hong Kong, China and Macao, China) wish to form a free trade agreement. Consistency of rules of origin across major trading hubs would simplify the process of establishing a region-wide free trade agreement—an Asian Free Trade Agreement. Each hub country is taken in turn:

Japan's Economic Partnership Agreements with Mexico and Singapore

Table 1: Japanese Bilateral Free Trade Agreements

Chapter	Mexico	Singapore
22 Beverages and Spirits	CTH VA (Regional, 50%)	CTH VA (Regional, 60%)
24 Tobacco	CTH VA (National, 70%)	CTH VA (Regional, 60%)
28 - 29 Chemicals	CTH VA (Regional, 50%)	CTH VA (Regional, 60%)
30 Pharmaceuticals	CTH VA (Regional, 50%)	CTH
57 Textiles	CTH	CTH
62 Clothing Apparel	CTH	CTH VA (Regional, 60%)
85 Electrical Machinery	CTH VA (Regional, 50%)	CTH

[6] A CTH standard was established for non-preferential rules of origin with use of a change in tariff subheading (CTSH) rule in instances where assembly was sufficient to confer origin where necessary. See James (2005) and Imagawa and Vermulst (2005) for discussion.

86 Transportation	CTH VA (Regional 50%, 65%)	CTH
90 - 91 Electronics	CTH VA (Regional, 50%)	CTH VA (Regional, 60%)
93 Arms and Ammunition	CTH	CTH

Source: World Trade Organization Regional Portal and Author's Compilations

Value added and CTH rules are typical in Japan's economic partnership (FTA) agreements with Mexico and Singapore. However, value-added requirements differ—with 50 per cent most often used for Mexico and 60 per cent for the agreement with Singapore. However, there is also differing sectoral coverage of value-added in the two agreements. For chapters 85 (electrical machinery) and chapter 86 (transportation equipment) the agreement with Mexico specifies VA thresholds of 50 per cent and, in some transport items, of 65 per cent, while the agreement with Singapore only requires a CTH. In clothing both agreements have different SP rules: cutting and sewing or otherwise assembling with Mexico but a "yarn-forward" requirement along with regional value content of 60 per cent for Singapore. This is a case of rules of origin providing less favorable treatment for an Asian partner compared a non-regional partner and raises the issue of whether such discrimination might stymie the efficient development of regional production networks within Asia. For tobacco products (chapter 24), the value-added threshold in the agreement with Mexico is 70 per cent compared with 60 per cent in the agreement with Singapore and in this case the treatment of Mexico is less favorable than Singapore. Only national content is counted towards meeting the 70 per cent content requirement—perhaps reflecting the lobbying of Japan's tobacco industry.

Rep. of Korea's Bilateral Free Trade Agreements with Chile and Singapore

Table 2: Rep. of Korea's Bilateral Free Trade Agreements

Chapter	**Chile**	**Singapore**
28 Inorganic Chemicals	CTH VA (National 45%, 30%)	CTH

29 Organic Chem.	CTH VA (Regional, 30%)	CTH * Detailed rules of origin
30 Pharmaceuticals	CTH	CTH
31 Fertilizers	CTH VA (National 45%, 30%)	CTH
32 Dyes	CTH VA (Regional 45%, 30%)	CTH
38 Misc. Chemical Products	CTH VA (Regional 45%, 30%)	CTH VA (Regional 55%)
61-62 Clothing	SP	CTH VA (Regional 55%) SP
64 Footwear	CTH VA (Regional 45%, 30%)	CTH
84 Machinery	CTH VA (Regional 45%, 30%)	CTH VA (Regional 55%) * Detailed rules of origin
85 Electrical Equipment	CTH VA (Regional 45%, 30%)	CTH VA (Regional 55%)
86 Transportation	CTH	CTH VA (Regional 55%)
87 Vehicles	CTH VA (Regional 45%, 30%)	CTH VA (Regional 55%)
89 Ships and Boats	CTH VA (Regional 45%, 30%)	CTH VA (Regional 55%)
93 Arms and Ammunition	CTH VA (Regional 45%, 30%)	CTH

Source: World Trade Organization Regional Portal and Author's Compilations

Rep of Korea has concluded two bilateral FTAs and these tend to specify value added and CTH rules in tandem. It is also important to note that the Korea-Singapore FTA includes a 10-year period for tariff reductions by Republic of Korea in clothing (chapters 61-62) and over a 5-year period for many textile products (Chapters 50-60). Value-added percentages vary according to methodology or formula used in calculations (45% minimum for "build-down" formula versus 30% for "build-up" formula) in the agreement with Chile. The VA requirement is higher in the agreement with Singapore, typically a minimum of 55% is required. Specified processes (cutting and sewing operations) are required for clothing in addition to CTH and VA rules. The stricter rules of origin coupled with the ten-year phase out of Korean tariffs implies discrimination against Singapore compared with Chile and again is not a good precedent for establishment of efficient Asian production networks.

People's Republic of China's Bilateral Free Trade Agreements

Table 3: PRC Bilateral Free Trade Agreements

Product	Hong Kong, China	Macao, China
Textiles Clothing Apparel	CTH SP	CTH SP
Machinery	CTH VA (National, 30%) SP	CTH VA (National, 30%) SP
Chemical Products	CTH SP	CTH VA (National, 30%)
Electronics	CTH VA (National, 30%) SP	CTH VA (National, 30%) SP
Pharmaceuticals	CTH SP	Not Accessed

Source: World Trade Organization Regional Portal and Author's Compilations

The PRC has concluded bilateral free trade agreements with two territories that are part of China but that remain as separate customs territories, Hong Kong, China, and Macao, China. These "Closer Economic Partnership Agreements" appear to have limited coverage in that agricultural products are not extensively provided duty-free access in the PRC market. In addition, coverage is much less in the agreement with Macao, China than for Hong Kong, China, reflecting the differences in industrial development between the two territories. For

most industrial products a specified process test is used as the main rule of origin without any value-added or content requirement as in the case of textiles and clothing. For clothing the process is sewing or otherwise assembling the garment. Where value-added is used as a rule (in some machinery and electronics products), the amount is consistent at 30%.

Singapore's Free Trade Agreements

Singapore has the most extensive network of free trade agreements of any country in the Asia-Pacific region. Not only is a party to the Association of Southeast Asian Nations (ASEAN) and its ten-member AFTA, its ASEAN plus agreements with PRC, Korea, Japan and India (all in the process of negotiations), but it has struck out on its own, reaching numerous bilateral free trade agreements, including with Japan and Korea (Tables 1 and 2 above). Singapore has concluded three additional free trade agreements that have been notified and are extensively documented on the WTO homepage, including agreements with the United States, the European Free Trade Association (Iceland, Norway and Switzerland) and the Trans-Pacific Special Economic Partnership (SEP) linking Singapore with New Zealand, Chile and Brunei (also an ASEAN and AFTA member).

Table 4: Singapore's Preferential Trade Agreements (PTA)

Chapter	United States	Trans Pacific SEP	EFTA
1, 2 Meats and Animals	CTH	CTH	CTH WO
3 Fish and Crustaceans	CTH SP	CTH	
4 – 8 Dairy Fruits and Vegetables	CTH	CTH	WO SP
28 Inorganic Chemicals Organic Chemicals	CTH SP * Detailed rules of origin	CTH SP	CTH VA 50% SP

30 Pharmaceuticals	CTH	CTH SP	
32, 33 Dyes	CTH SP	CTH VA (Regional 45%)	CTH VA 50% SP
39 Plastics	CTH SP	CTH VA (Regional 45%) SP	CTH VA 50% SP
61, 62 Clothing	CTH SP	CTH VA (Regional 50%) SP	CTH VA 50%
63 Textiles	CTH SP	CTH VA (Regional 50%)	SP VA 50%
64 Footwear	CTH VA (Regional 55%)	CTH VA (Regional 50%)	SP VA 40%
74 – 80 Metals	CTH	CTH VA (Regional 45%)	CTH VA 50%
84 Machinery	CTH VA (Regional 45% up, 35% down)	CTH VA (Regional 45%)	CTH VA 50%

85 Electrical Equipment	CTH VA (Regional 45% up, 35% down)	CTH VA (Regional 45%)	CTH VA 50%
86 Vehicles	CTH VA (Regional 30%)	CTH VA (Regional 45%)	CTH VA 50%
88 Aircraft	CTH VA (Regional 45% up, 35% down)	CTH	CTH
89 Ships	CTH VA (Regional 45% up, 35% down)	CTH VA (Regional 45%)	CTH VA 50%
93 Arms and Ammunition	CTH VA (Regional 45% up, 35% down)	CTH VA (Regional 45%)	VA 50%

Source: World Trade Organization Regional Portal and Author's Compilations

Rules of origin are most detailed in the US-Singapore FTA with nearly 300 pages of product-specific rules of origin. In textiles and clothing complex rules of origin were adopted despite the fact that Singapore is a very minor producer and exports little of these products. The FTA with the US provides some flexibility in allowing choice between "build-up" (45%) and "build-down" (35%) to calculate regional content. In vehicles (chapter 86) a less stringent 30% build-up content rule is applied. The four-party Trans-Pacific SEP free trade area has less stringent rules of origin than the other two

agreements in Table 4. However, in clothing chapters the rules are inclusive of a CTH, VA of 50% minimum and cutting and sewing operations. The free trade agreement with the three EFTA countries (Iceland, Norway and Switzerland) provides mainly for a maximum non-originating content rule of 50% (40% for footwear) and is generally less detailed in clothing chapters than the other agreements. The value added rules are different between the three agreements in specifics even though the amounts do not vary much in principle.

Thailand's Bilateral Free Trade Agreements

Aside from Singapore, Thailand has been the most prolific Asian participant in bilateral free trade agreements even though it is also a charter member of ASEAN and AFTA. However, Thailand's free trade negotiations with the US, Japan and other partners have been bogged down as a result of political problems the country has been experiencing. Disputes over coverage of agriculture with Japan (Thailand is a major rice exporter and Japan has very high rice trade barriers) and over the patenting of pharmaceutical products in which the US drug industry has strong interest have impeded the conclusion ot these bilateral negotiations. Nonetheless, Thailand has successfully concluded bilateral Free Trade Agreements with both Closer Economic Relationship (CER) member countries, Australia and New Zealand. Both these FTAs have been notified to WTO and have entered into force.

Table 5: Thailand's Bilateral Free Trade Agreements

Chapter	Australia	New Zealand
1, 2 Meats and Animals	CTH	CTH
3 Fish and Crustaceans	CTH SP	CTH WO
4 – 8 Dairy Fruits and Vegetables	CTH * Detailed rules of origin	CTH
28 Inorganic Chemicals Organic Chemicals	CTH SP	CTH
30 Pharmaceuticals	CTH	CTH

32, 33 Dyes	CTH SP	CTH
39, 40 Plastics and Rubber	CTH SP	CTH WO
58 Textiles	CTH VA (Regional 55%)	CTH VA (Regional 50%)
61, 62 Clothing	CTH VA (Regional 55%) SP	CTH VA (Regional 50%)
64 Footwear	CTH VA (Regional 55%)	CTH
74 – 80 Metals	CTH VA (Regional 45% - 50%)	CTH
84 Machinery	CTH VA (Regional 40% - 45%)	CTH
85 Electrical Equipment	CTH VA (Regional 40% - 45%)	CTH
86 Transportation	CTH VA (Regional 45%)	CTH
87 Vehicles	CTH VA (Regional 45%)	CTH
88 Aircraft	CTH VA (Regional 45%)	CTH
89 Ships	CTH VA (Regional 45%)	CTH
93 Arms and Ammunition	CTH VA (Regional 45%)	CTH

Source: World Trade Organization Regional Portal and Author's Compilations

The rules of origin are very detailed in these two agreements, particularly with Australia (286 pages of product specific rules). Despite the fact that Australia and New Zealand have their own common rules of origin under the CER, they have adopted

different approaches in bilateral agreements with Thailand. Australia has made extensive use of a value-added rule in many manufacturing sectors and has adopted higher value added rules for textiles and clothing than New Zealand. This indicates that harmonization and consistency in rules of origin is not a practical priority in bilateral trade negotiations. If the CER does not follow a common template, then who will?

The review of product-specific rules of origin for manufactured goods in free trade agreements entered into recently by major Asian hub economies reveals that rules of origin are different across hubs. Rules of origin are highly idiosyncratic even within agreements entered into by a hub country. The range of value-added rules (from 30% at the low end to 70% at the high end) masks even more variation when one examines rules of origin on a product-by-product basis. For example, in textiles there are maximum allowances for non-originating yarn and fabric of 10% of weight in some of these agreements in addition to the overall regional content requirements. Rules of origin in these agreements may not be harmonized across hubs, let alone within hubs. Hence, the spaghetti-bowl problem appears to be very serious and will make it extremely difficult for businesses to take advantage of these agreements without incurring significant compliance costs.

Tariff Discrimination Resulting From PTAs: Some Examples From Industries of Interest to Developing Countries

In a world of very low MFN tariff rates and few or no non-tariff border barriers to trade, rules of origin would become fairly benign and would be mainly used to determine direction of trade statistics and to enforce contingent measures (prevention of circumvention of antidumping measures) and as a way to regulate practices such as trans-shipment. However, one of the most important features of preferential trade agreements is the margin of tariff preference they provide to member countries relative to non-members. It is well-known that most countries still maintain high peak tariffs in "sensitive" industries, as well as in agriculture, and that industrial lobbies are well-represented in trade negotiations and legislative matters. In addition to peak tariffs on clothing, textiles and footwear, the escalation of tariffs by degree of processing remains a reality in most countries. Thus, preferential trade agreements, particularly full-blown free trade agreements have potentially strong tariff discrimination against non-members, enforced often by highly restrictive and idiosyncratic rules of origin. One of the objects of the Doha Development Agenda was to substantially reduce peak tariffs and tariff escalation in manufacturing industries through the Non-Agricultural Market Access (NAMA) negotiations that had adopted the Swiss Formula for tariff reductions and to compensate least developed countries that would see an erosion of their margins of preference by providing them duty-free and quota-free access to major industrial country markets. However, with the collapse of the WTO talks, it will be several years before these goals are likely to be achieved, if at all. In the meantime, with a proliferation of FTAs, tariff discrimination is a persistent and serious problem of market access, particularly for low and mid-income developing countries in Asia. This problem is

illustrated in the largest market for Asian labor-intensive manufactured exports in the world—the United States.

Actual duty collection data on three major import product categories (clothing, textile intermediate products and footwear) was obtained from the United States International Trade Commission homepage. The duties collected were divided by the customs value of imports in each category for 2005. The resulting percentage of effective duty charged indicates the margin of preference realized by preferential trade partners as opposed to non-preferential suppliers, including Asian suppliers, of these products in the US market. The tables include preferential suppliers in reciprocal trade agreements (Free Trade Agreements) like NAFTA and CAFTA-DR, but also those enjoying enhanced market access through non-reciprocal special preference programs: CBI, ATPDA, and AGOA.[7]

The difference between MFN tariffs and preferential tariffs is biggest in the clothing sector, as peak US tariffs on synthetic fiber clothing top 30 per cent, and while tariffs on cotton clothing are somewhat lower, they are still quite high relative to the manufacturing average tariff, frequently 15 per cent or more. Thus, the gap between duties collected on shipments of clothing from competitive Asian suppliers and those collected on shipments from preferential suppliers (table 6) is very substantial. On average, non-preferential suppliers to the US market paid nearly 12 per cent more duty per shipment than preferential suppliers (14.32 per cent versus 2.52 per cent). The potential for trade diversion in the post-quota era in clothing trade is therefore very substantial. Furthermore, some of the Asian suppliers may move into the preferential camp (particularly Korea and Malaysia but also possibly Thailand) and this could increase the difficulties facing suppliers without FTA possibilities in the period up to June 2007 when TPA shuts down. In particular, Asian suppliers with low-cost labor such as Bangladesh, Cambodia, Viet Nam and Indonesia face severe tariff discrimination in the US market. Access to the US market via the Generalized System of Preferences (GSP) may be one avenue to reduce the tariff discrimination inherent in bilateral US trade programs and special non-reciprocal PTAs. This issue is examined below in Section VI.

For intermediate textile products, US MFN tariffs are lower than for clothing but are still frequently in double-digits leading to a substantial margin of preference for members of preferential arrangements. Asian yarns and fabrics directly compete with US producers of yarn and fabric in the US market but must overcome a ten per cent average effective duty rate versus US producers (table 7). They also compete with large preferential suppliers like Mexico and Canada that effectively pay a miniscule duty rate of about one-quarter of one per cent and thus have a margin of preference over non-preferential suppliers of nearly 10 per cent.

[7] NAFTA is the North American Free Trade Agreement, CAFTA-DR is the Central American Free Trade Agreement-Dominican Republic, CBI is the Caribbean Basin Initiative, ATPDA is the ANDEAN Trade Promotion and Drug Eradication Act and AGOA is the African Growth ant Opportunity Act. See Tables 6-8 for the list of member countries in these agreements.

Table 6. Import Duty Paid on Shipments of Clothing to the United States in Post Quota Era (Millions of US $; % of Customs Value)

Supplier Group/Country	Duty Paid	Customs Value	Duty %
Competitive Asian Suppliers:			
Indonesia	531.33	2,972.42	17.88
Philippines	314.71	1,851.05	17.00
Viet Nam	464.13	2,736.01	16.97
Bangladesh	388.58	2,373.25	16.37
Cambodia	280.12	1,713.77	16.35
Sri Lanka	272.38	1,693.96	16.08
Pakistan	206.44	1,340.76	15.40
India	468.71	3,150.22	14.88
Thailand	292.15	2,218.81	13.17
PRC	2,253.06	19,888.44	11.33
Malaysia	121.60	1,225.99	9.92
Former Asian Large Quota Holders:			
Taipei, China	233.61	1,203.23	19.41
Hong Kong, China	650.13	3,353.66	18.29
Macao, China	210.07	1,199.32	17.52
Korea, Rep. of	219.38	1,253.15	17.51
Small Asian Suppliers			
Mongolia	24.63	134.41	18.32
Lao PDR	0.50	2.80	16.08
Nepal	9.47	61.49	15.41
Maldive Islands	0.38	4.72	8.10
Other Major Non-Preferential Suppliers			

Turkey	153.49	976.15	15.72
European Union	342.22	2,573.49	13.29
Sub-Total Non-Preferential Suppliers	7,437.09	51,927.10	14.32
Preferential Suppliers:			
Canada	7.51	1,468.26	0.51
Mexico	36.47	6,321.39	0.58
Israel	2.76	292.35	0.94
ANDEAN	30.52	2,014.51	1.52
Jordan	2.94	1,082.55	2.71
AGOA	6.91	1,463.32	4.72
CAFTA-DR	439.60	9,193.85	4.78
Egypt	35.03	443.94	7.89
Sub-Total Preferential Suppliers	561.74	22,280.17	2.52

-Note: Data are for Calendar Year 2005.
-Duty paid percentages reported may differ slightly from calcuations inferred from tabular data due to rounding.
-ANDEAN (Andean Trade Preference and Drug Eradication Act) includes Bolivia, Colombia, Ecuador and Peru.
-African Growth and Opportunity Act (AGOA) includes Angola, Benin, Botswana, Burkina Faso, Cameroon, Cape Verde, Chad, Congo (DROC), Congo (ROC), Djibouti, Ethiopia, Gabon, Gambia, Ghana, Guinea, Kenya, Lesotho, Madagascar, Malawi, Mali,Mauritania, Mauritius, Mozambique, Namibia, Niger, Nigeria, Rwanda, Sao Tome and Principe, Senegal, Seychelles, Sierra Leone, South Africa, Swaziland, Tanzania, Uganda, and Zambia.
-The Central America Free Trade Area (CAFTA-DR) includes Dominican Republic, Guatemala, Costa Rica, El Salvador, Honduras and Nicaragua.

Table 7. Import Duty Paid on Shipments of Textiles to the United States in Post Quota Era (Millions of US $; % of Customs Value)

Supplier Group/Country	Duty Paid	Customs Value	Duty %
Competitive Asian Suppliers:			
Indonesia	6.64	54.98	12.07
Malaysia	1.82	15.19	11.98
Thailand	7.42	65.76	11.28
Viet Nam	0.74	6.69	11.05
PRC	58.99	587.47	10.04
Pakistan	27.91	294.91	9.47
India	10.70	159.42	6.71
Former Asian Large Quota Holders			
Taipei, China	26.95	213.92	12.60
Korea, Rep. of	33.49	284.60	11.77
Hong Kong, China	2.34	24.92	9.38
Major Non-Asian Non-Preferential Suppliers			
Turkey	10.33	110.85	9.32
Italy	23.81	272.78	8.73
Brazil	1.42	19.78	7.17
Sub-Total Non-Preferential Suppliers	212.56	2,111.27	10.07
Major Preferential Suppliers			
Mexico	0.05	197.53	0.02
Canada	0.50	255.51	0.20
Israel	0.03	18.43	1.68

Mexico	0.05	197.53	0.02
Canada	0.50	255.51	0.20
Israel	0.03	18.43	1.68
CAFTA-DR	0.33	7.13	4.56
Sub-Total Preferential Suppliers	0.91	478.60	0.19

Note: Data are for Calendar Year 2005. Duty paid percentages reported may differ slightly from calcuations inferred from tabular data due to rounding.

The Central America Free Trade Area (CAFTA-DR) includes Dominican Republic, Guatemala, Costa Rica, El Salvador, Honduras and Nicaragua.

Moreover, rules of origin particularly target intermediate textile products in order to protect the US textile sector and provide strong incentives for preferential suppliers to use US yarns and fabrics, particularly the smaller preferential suppliers such as those in Central America as these suppliers lack textile spinning and weaving capacities. US yarn and fabric can enter these markets duty free for processing into ready made garments which then enter the US market duty free. Under CAFTA-DR, Mexican suppliers of fabric also may enter these six markets duty-free for processing and can then enter the US market as garments duty-free. Thus, the US hub and spoke system doubly discriminates against non-preferential suppliers.

Footwear is an important export product for several Asian countries, particularly for the PRC. However, footwear shipments to the US face severe tariff discrimination and preferential suppliers enjoy a margin of preference averaging ten per cent (table 8). This is not a deterrent enough to prevent the PRC from attaining a dominant share of the market. However, the tariff discrimination requires PRC suppliers to cut costs to the very bone.[8] Other big Asian suppliers face even worse tariff discrimination than the PRC, with Indonesia and Viet Nam paying 11 per cent more duty per shipment than preferential suppliers.

[8] For example, the producer of a pair of boots that retail for $49.99 in the U.S., receives only $15.30 including a profit of $0.65 and wage costs of $1.30 per pair of boots. The U.S. retailer earns $3.46 per pair (excluding tax and interest payments). See Thomas Fuller, "Trade imbalance masks a struggle to get by: Boots made in China but Money Made in U.S., *International Herald Tribune*, August 4, 2006, pages 1 and 12.

Table 8. Import Duty Paid on Shipments of Footwear to the US Market (value in US$ millions; Duty % of Customs Value)			
Supplier Group/Country	Duty Paid	Customs Value	Duty %
Competitive Asian Suppliers:			
Indonesia	58.77	510.19	11.52
Viet Nam	82.05	716.21	11.45
Thailand	31.50	291.76	10.80
PRC	1,289.72	12,654.22	10.19
India	12.14	139.09	8.72
Asian NIEs			
Hong Kong, China	5.07	52.49	9.65
Taipei, China	6.42	69.18	9.27
Korea, Rep. of	4.10	45.33	9.05
Major Non-Asian Non-Preferential Suppliers			
Italy	114.45	1,137.05	10.07
Brazil	98.39	1,019.20	9.65
Sub-Total Non-Preferential Suppliers	1,702.61	16,634.72	10.24
Major Preferential Suppliers			
Mexico	0.62	247.21	0.25
ANDEAN	0.07	9.64	0.71
Canada	0.12	93.57	0.12
CAFTA-DR	0.44	151.04	0.29
Sub-Total Preferential Suppliers	1.25	501.46	0.25

Note: Data are for Calendar Year 2005. Duty paid percentages reported may differ slightly from calcuations inferred from tabular data due to rounding.

The ANDEAN Trade Preference and Drug Eradication Agreement includes Bolivia, Colombia, Ecuador and Peru.

The Central America Free Trade Area (CAFTA-DR) includes Dominican Republic, Guatemala, Costa Rica, El Salvador, Honduras and Nicaragua.

Source: United States International Trade Commission Datawebb and Author's Compilations.

Rules of Origin Impact on Utilization of PTAs by Developing Countries: The Case of the United States

The United States provides preferential access to its market through several routes. The oldest and perhaps best known preference program is the Generalized System of Preferences (GSP) that is open to most developing economies belonging to the World Trade Organization (successor to the General Agreement on Tariffs and Trade). GSP is generally open to low and lower-middle income developing countries and least developed countries including those in Asia and the Pacific.[9] In addition to the GSP, the US has more recently provided preferential access under a series of non-reciprocal preference programs aimed at providing more generous access to small developing and least developed countries. These include the Caribbean Basin Initiative (CBI) that allows the countries of the Caribbean Basin Region (excluding Cuba) access to the US market for ready-made garments. Similarly, the US has provided access to the countries of Sub-Saharan Africa under the African Growth and Opportunity Act (AGOA). A special program called the Andean Trade Promotion and Drug Eradication Act (ATPDA, referred to herein as ANDEAN) provides similar access to countries in South America cooperating with the US in efforts to eradicate illegal narcotics trade. For Middle Eastern countries, a special program called the Qualified Industrial Zones (QIZ) also provides preferential access to the US market for clothing. These agreements, like the GSP, provide access that is limited (capped at a certain volume of imports) after which MFN tariffs become applicable should shipments exceed the agreed limits. Each of these programs is enforced by a set of rules of origin or what might also be deemed rules of preference. Participation in the special programs has evolved into a process whereby the partner countries are eventually encouraged to negotiate a bilateral free trade agreement (FTA) with the US that involves reciprocation of preferential tariff treatment and, in theory, more comprehensive access to the US market.

Under the GSP, Asian and Pacific developing countries have very limited access to the US market because of strict limitations on the volume of imports permitted to enter duty free and due to the near exclusion of most sensitive labor-intensive products such as textiles, garments and footwear. The utilization of US GSP currently is quite low in most beneficiary countries in the Asia-Pacific region. Utilization ratios are computed for the most recent period possible for Asian and Pacific developing countries defined as the percentage of total shipments to the US market receiving GSP (table 9). In most cases,

[9] The Asian Newly Industrialized Economies: Hong Kong, SAR, Rep. of Korea, Singapore and Taipei, China have all graduated from the GSP. The PRC is excluded from GSP under the terms of its WTO Accession Agreement with the US.

small and isolated developing countries have very low utilization rates. Only two countries have utilization rates of over 50 per cent (Armenia and Kazakhstan) and in both cases GSP is overwhelmingly accounted for by a few product chapters (precious stones and minerals) that fortuitously are granted US GSP and that dominate shipments to the US. Larger developing Asian countries with diversified exports like India, Indonesia and Thailand have relatively high GSP utilization ratios but in no case do the rates much exceed a quarter of shipments.[10] Pacific Islands have low rates of utilization with the exception of Fiji and Samoa (again a case where import shipments in only a couple dominant processed agricultural products receive GSP). Restrictive rules of origin and exclusion of products of most interest to developing countries explain the relatively low utilization of GSP.[11]

In contrast to GSP, special US non-reciprocal preference programs have provided access for textiles and clothing and have much higher utilization rates. The percentage of shipments to the US covered by the CBI, ANDEAN and AGOA special preference programs reach between 70 and 90 per cent of all shipments to the US market (Figure One).

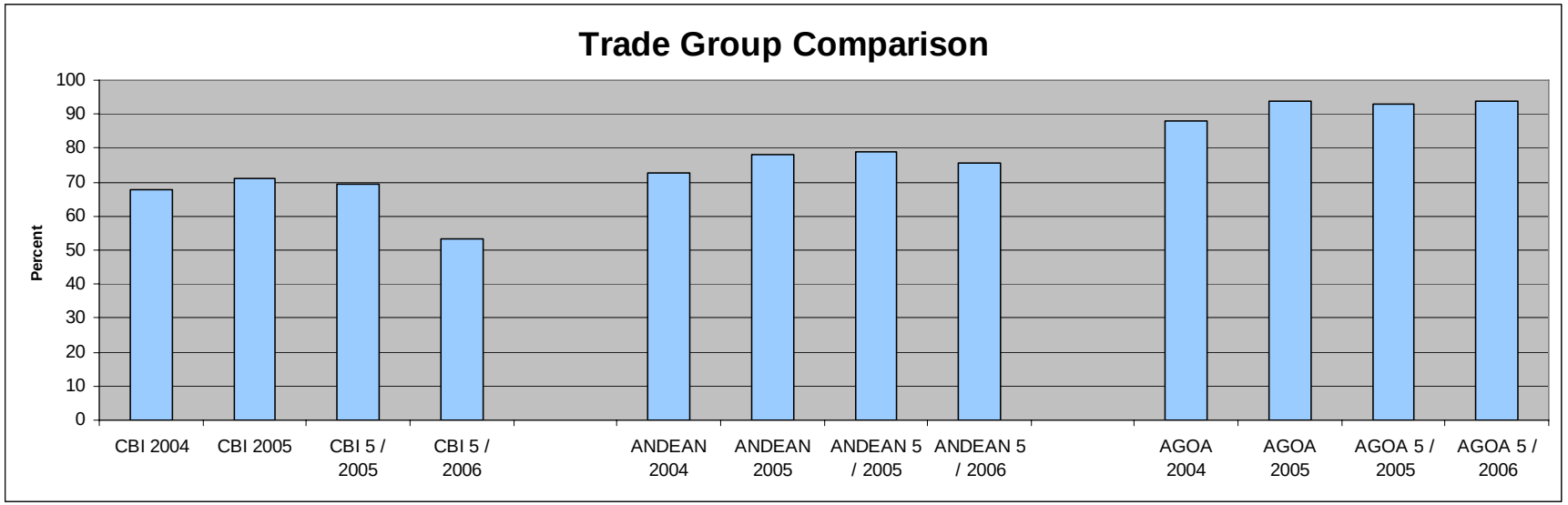
[10] Following the suspension of the Doha Round Talks in July 2006, the Bush administration announced it was reviewing GSP preferences for India and 12 other countries that made relatively high use of the program. The US GSP expires at the end of 2006 subject to Congressional renewal. See *Hindustan Times* August 10, 2006.

[11] This study has focused upon a case study of the United States but other studies are being conducted along similar lines for other OECD countries with GSP programs. In particular, see Lippoldt (2006) for a study of utilization of Australia's GSP.

Table 9. GSP Utilization Ratios in Developing Asia-Pacific Countries: % of Total Imports Shipments to US Market				
GSP Beneficiary	2004	2005	YTD 2005	YTD 2006
Asia				
Afghanistan	0.10	17.07	0.14	0.81
Armenia	58.65	58.65	58.65	58.65
Bangladesh	0.70	0.80	0.77	0.68
Bhutan	0.00	1.79	1.62	0.00
Cambodia	0.31	0.27	0.32	0.29
India	25.84	24.77	22.73	25.39
Indonesia	11.66	13.04	12.31	14.07
Kazakhstan	29.30	19.11	25.67	51.42
Kyrgyz Rep.	0.45	0.22	0.04	0.33
Maldive Is.	0.00	0.00	0.00	0.00
Mongolia	0.06	0.11	0.09	0.31
Nepal	2.23	2.99	2.63	3.39
Pakistan	3.28	2.97	3.03	3.39
Philippines	10.90	10.92	11.48	11.93
Sri Lanka	5.89	6.63	6.53	6.40
Tajikistan	3.89	12.66	6.08	4.08
Thailand	18.12	18.07	16.90	15.79
Uzbekistan	3.89	12.66	6.08	4.08
Pacific Islands				
Cook Is.	0.20	0.40	0.41	0.00
Kiribati	0.00	0.00	0.00	0.00
Fiji	16.58	35.03	29.40	29.22
Papua New Guinea	4.80	4.94	0.61	0.15
Samoa	10.49	43.08	39.22	44.83
Soloman Is.	0.14	0.00	0.00	0.43
Tonga	4.74	3.69	2.55	1.84
Vanuatu	0.78	2.01	6.89	6.87

Source: Author's Compilations and
United States International Trade Commission: http://www.usitc.gov

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



Note: CBI is the Caribbean Basin Initiative and includes Barbados, Costa Rica, Dominican Rep., El Salvador, Guatemala, Guyana, Honduras, Nicaragua, Panama, St. Lucia, Trinidad and Tobago. ANDEAN includes Bolivia, Colombia, Ecuador and Peru. AGOA is the African Growth and Opportunity Act and includes Botswana, Cape Verde, Ethiopia, Ghana, Kenya, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Rep. of South Africa, Swaziland, Tanzania, Uganda and Zambia.

The relatively high ratio of preferential to total imports in these groups indicates that without the preferential treatment shipments to the US would be much smaller than those realized. However, the US also sets quantitative limits on shipments in a given US fiscal year (October 1, 2004 to September 30, 2005, for example) under the Trade and Development Act of 2002, which covers the African Growth and Opportunity Act, the Caribbean Basin Trade Partnership Act and the ANDEAN Trade Promotion and Drug Eradication Act. [12]

The "fill rate" of these quantitative limits which are quantified in square meter equivalents of qualifying fabric are well below the utilization ratios of preferential imports to total imports. For AGOA the fill rate in FY 20005 was just 34.4 per cent (370 million SME out of a total preference level of 1,077 million SME). AGOA allows lesser developed sub-Saharan African countries to use third country fabric (most of it from Asia) and with this allowance the fill rate in FY 2005 was 64 per cent (343 million SME out of 536 million SME).[13] In contrast, in the ANDEAN Region the fill rate was a miniscule 4 per cent (25 million SME out of 710 million SME). For the Caribbean Basin Region the fill rate was 61 per cent (596 million SME out of 970 million SME) with cotton t-shirts achieving a fill rate of 99 per cent (11.9 million dozen pairs out of 12 million dozen pairs allowed). The reason for the low fill-rate in ANDEAN appears to be the use of a restrictive "yarn-forward" rule of origin (similar to that of NAFTA) while for the other two regions simple assembly of garments from qualifying fabric is the rule of origin. These preference programs are strictly limited to garments and luggage (made up from textiles) and hence are inherently restrictive. This is one reason why US partners under these programs have sought to negotiate free trade agreements that by definition offer broad coverage of "substantially all" trade as required by GATT Article XXIV. The QIZ programs for Middle Eastern countries (Jordan and Egypt) offer preferences over a wider group of products than under the Trade and Development Act of 2002. QIZ preferences covered almost 85 per cent of shipments from Jordan in 2004 but coverage began to drop in 2005 and 2006 as the US-Jordan FTA began to gradually cover more trade (see Table 10 below). In the case of Egypt, the QIZ was launched in 2005 and covered 12.8 per cent of shipments to the US and in 2006 (January-May) the utilization ration rose to 21.4 per cent of shipments. In the case of Jordan, clothing accounts for three-quarters of qualifying imports and the high use of the preferences is facilitated by a simple rule of origin: sewing or assembly of qualifying fabric into garments. The QIZ program was a precursor to the US-Jordan FTA.

In contrast to non-reciprocal preference programs, free trade agreements tend to be more comprehensive in coverage of trade and are also involve reciprocal exchange of preferential market access. In general, US free trade agreements involve very comprehensive and detailed product-specific rules of origin. This is certainly the case in NAFTA where rules of origin cover several hundred pages. The free trade agreements

[12] Under the 2002 Act, the Caribbean Basin Trade Partnership Act (CBTPA) covers a subset of the CBI countries (Costa Rica, Dominican Republic, Guatemala, Haiti, Honduras, Jamaica, Nicaragua, and El Salvador).

[13] Data are from the Office of Textiles and Apparel (OTEXA) of the US Department of Commerce: http://www.otexa.gov

that the US has negotiated and that have entered into force were examined in order to estimate the share of US imports from FTA partners that made use of preferential tariff treatment (Table 10). In the case of NAFTA (1994), preferential imports from Canada were as high as 88 per cent of total shipments in 2005 up from 82 per cent in 2004, whereas for Mexico the ratio was far lower at 62-63 per cent. This may be due to the composition of trade but is also likely to reflect the greater difficulty a developing country has in complying with rules of origin compared with a developed country. In particular, value-added requirements ranging from 50-62.5 per cent may be more difficult for Mexican enterprises to meet than those in Canada. Chile has a deal similar to Mexico and Canada with the US and has achieved a preference ratio of 55-56 per cent in 2005-2006, up from 42 per cent in 2004, the initial year of the agreement. US free trade agreements with Israel (1985), Jordan (2001) and Singapore (2004) have much lower preference ratios than those with Canada, Chile and Mexico.[14] Australia is likely to attain a high level of preference coverage in its shipments to the US over the course of time as the agreement only took effect in 2005 (36 per cent preference ratio) and coverage appears to be rising sharply in 2006. It is too early to judge how much trade CAFTA-DR will cover as the agreement only entered into force in March 2006. Similarly, for Morocco it is too early to tell, although the coverage attained already exceeds that of Israel.

The impact of US-based free trade agreements is likely to be significant on bilateral trade flows between partners and between partners and non-partners. The relatively high MFN tariffs on key labor-intensive manufactured goods coupled with restrictive rules of origin make it likely that US-hub FTAs will lead partners to purchase intermediate goods from within the bloc and to reduce purchases from lower-cost sources outside the block. Research using a gravity model (IMF 2006) indicates that NAFTA members on average trade 33 per cent less with nonmembers than otherwise. The finding that membership in NAFTA reduces the willingness of the US to reduce MFN tariffs on goods receiving tariff preferences (Limao 2006) underscores the threat that reciprocal preferential trade agreements pose for multilateral trade liberalization.

In contrast to US-hub free trade agreements, research has shown that the ASEAN Free Trade Area (AFTA) has had little impact on intra-bloc trade flows (Baldwin 2006). Moreover, research indicates that ASEAN members trade more intensively with non-members than do NAFTA members (IMF 2006). However, the recent trend towards expansion of bilateral trade agreements that are centered around large hub countries (Japan, Korea, China) or that involve complex rules of origin and significant margins of preference could weaken the will of Asian countries to continue to support multilateral trade liberalization and may also slow down or bring a halt to unilateral liberalization efforts that have served Asia well in the recent past. One of the main dangers is that a

[14] In the case of Jordan, almost all shipments to the US receive preferential treatment once the QIZ and GSP preferences are taken into account. In 2005, 95 per cent of shipments to the US received preferential treatment (19.5 per cent under the FTA, 74.5 per cent under the QIZ and 1.5 per cent under GSP). The reason for low coverage in the case of Singapore needs further examination, but it is likely that much of what Singapore ships to the US comes in under zero or low tariffs (electronics and information technology products).

complex web of bilateral free trade agreements will conflict with what Baldwin (2006) refers to as "the smooth functioning of Factory Asia." In other words, the efficient functioning of production networks based on open multilateral trade may give way to diversion of trade inside the bloc or hub-spoke system, thereby reducing the competitiveness of Asian products in world markets. This threat appears to be very real given the increasingly complex and differentiated rules of origin in bilateral agreements Asian hub countries are entering into.

Proposals for Disciplines and Reform in Use of Rules of Origin

Rules of origin related to the granting of preferential tariff treatment are at present not covered by any binding disciplines in the multilateral trading system (James 2005). The exclusion of preferential rules of origin from the work program on rules of origin under the Uruguay Round Agreement (GATT 1994) indicates that contracting member states wished to preserve their freedom to design preferential rules of origin rather than to agree to harmonization as for non-preferential rules of origin. In view of the subsequent exponential rise in the number of preferential trade agreements among contracting members since the agreement of 1994, however, it may be high time to review the omission of preferential rules of origin and to include them in the rules component of the Doha Round Agenda.

In the non-binding statement on preferential rules of origin, contracting members were admonished to ensure that rules of origin do not in themselves constitute obstacles to expansion of trade. Coupled with the admonition in Article XXIV of GATT and Article V of GATS that preferential trade arrangements not raise barriers to the commerce of non-members and that they not constitute an obstacle to reduction of MFN tariffs, the basis for some discipline over preferential rules of origin may be established. Moreover, a WTO panel decision that upheld India's complaint regarding EU preferences extended on a discriminatory basis to contracting members deemed to have cooperated in anti-narcotics efforts and that had been a source of contraband to the exclusion of contracting members that had not been such a source, also seems to lay the basis for limits on exceptions to Article I and the rules of origin necessary to enforce such exceptions.[15]

The difficulties encountered by the working group on non-preferential rules of origin in harmonization are a strong indicator that the goal of enhanced disciplines over preferential rules of origin should be realistic. Harmonization of preferential rules of origin may be too much to expect. Rather, some flexibility should be considered so that such rules do not in themselves constitute barriers to commerce. In general, preferential rules of origin should be based upon the same template as non-preferential rules of origin—that is on a CTH test. Such a test is not appropriate or applicable to all types of

[15] The India-EU GSP case documents are available at the homepage of the WTO: http://www.wto.org also see *Bridges Weekly Trade News Digest*, 5 November, 2003 for a summary of the case.

goods and services. Hence, they must be supplemented by percentage or specified process rules as is appropriate. The approach should be consistent with that of the work program on non-preferential rules of origin. Thus, in cases where assembly of a product is a substantial transformation, yet involves no CTH a Change in Tariff Sub-Heading (CTSH) test coupled with a minimum regional content rule should be adopted.

One way to approach the issue of disciplines would be to allow enterprises some leeway in meeting rules of origin by, for example, giving them a choice between a minimum regional content value added rule or a maximum non-originating content rule on one hand and a specified manufacturing process rule on the other hand. Standardization of accounting principles and formulae used to implement rules of origin could also simplify the situation for businesses wishing to take advantage of tariff preferences. Firms should also be allowed to average compliance with minimum regional content rules or maximum non-originating content rules over a period of time rather than having every single shipment in full compliance. Hence, if the VA rule is 50 per cent regional content and a firm ships $1million with 45 per cent regional content and another $1 million with 55 per cent regional content, the authorities should allow both shipments to enjoy preferential treatment, perhaps retroactively provided the firm can supply the relevant documentation to customs. In this context, the reform of Canada's GSP rules of origin may provide a useful model. In 2001, Canada revised its regional content rule to allow designated least developed countries a maximum of 60 per cent non-originating content (equivalent to 40 per cent regional content) as opposed to the general GSP requirement of a maximum of 40 per cent (equivalent to a 60 per cent regional content rule).[16] In 2003 Canada further liberalized its GSP rules of origin by extending coverage to textile and clothing products (among others) and this has proven to be beneficial to a number of least developed Asian countries including Bangladesh and Cambodia.

In addition to efforts to increase flexibility and choice, contracting members may also wish to strengthen the observance of the requirements of Article XXIV and Article V in new free trade agreements and to set a timeframe for existing agreements under the enabling clause to also gradually comply with those requirements. This is unlikely to be acceptable to many individual contracting members, however, collectively it is in the interest of the overall efficiency of multilateral trade to enforce such requirements and could be a component of the new rules under the Doha Development Agenda should the talks be revived.

A related recommendation to those above is that member countries of either a regional or bilateral PTA/FTA be required to publish statistics on the level of utilization of the preferences by estimating the percentage of imports of each member that are covered by and make use of the preferential tariffs. Such information is readily available to customs authorities and should be shared through national statistical agencies. The information would be very useful to governments in monitoring the performance and compliance of such agreements with GATT/WTO requirements and their impact on private commerce.

[16] See UNCTAD (2001 and 2005) for discussion.

Within Asia and the Pacific caution is now needed as the plethora of bilateral deals centered on large trading hubs is leading to increasing tariff discrimination within the region. Clearly, the way forward that minimizes the creation of discriminatory hub-spoke systems around the larger Asian traders is desirable. In this context, ASEAN might be considered the fulcrum for broader regional trading arrangements and thus connect the spokes as well as the hubs via the ASEAN plus 3 agreements with Japan, PRC and Republic of Korea as well as arrangements involving cooperation with India and the other SAARC member states. In this context, Asia and the Pacific might opt for a system of "Pan-Asian and Pacific Cumulation" similar to the Pan-European Cummulation Systme (PECS) adopted by the EU in 1997 and that was extended to Turkey in 1999 (The Economist, August 5, 2006). Such a system would allow member states to cumulate value-added across agreements in order to comply with rules of origin. Such a system would enable Asian production networks to thrive rather than becoming a casualty of restrictive rules of origin.

There are several related concerns that the Doha Round was meant to address but that are now in limbo. First, the explosion of bilateral deals is usually amongst the more advanced developing countries and threatens to leave poor, small and isolated countries behind. Second, even if these developing countries could enter into negotiations with more advanced partners, asymmetrical bargaining power would place them in a disadvantageous position. Third the erosion of preference margins that Doha intended to address by providing duty-free and quota-free access to 97 per cent of tariff lines is off leaving the poor countries with poorer market access prospects than with the Doha Round. These issues cannot really be adequately addressed in bilateral trade agreements and thus, the trend towards increased bilateralism in hub-spoke systems threatens to leave poor, small and isolated countries worse off.

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