

Effects of Rules of Origin on the European Union – Africa Economic Partnership Agreements: Summary of issues

Rules of Origin (ROO) determine the economic nationality of an imported product. Where margins of trade preferences are higher, ROO tend to be very restrictive and even sometimes dilutes the benefits of such preferences. As the ACP-EU Economic Partnership Agreement (EPA) negotiations enter a critical phase, the devil of the agreement will be in the detail of the impending EPAs ROO. According to the original mandate, EPA is supposed to be concluded by December 2007 and should be development friendly. Yet, the recent EC ROO offer to the ACP countries (Commission Staff Working Document Concerning the Definition of “Originating Products and Methods of Administrative Cooperation”) are seen by commentators as completely undermining the development dimension of EPA. Bearing in mind the current EPA negotiations, Roberto Rios explains how ROO impact the pattern of trade between countries and how they can be development friendly.

I. Introduction

Rules of Origin (ROO) determine the economic nationality of an imported product. Where margins of trade preferences are higher, ROO tend to be very restrictive and even sometimes dilutes the benefits of such preferences. In the context of the current EPA negotiations, the implementation of simpler and development friendly ROOs is therefore a point of key importance in ensuring that ACP producers and their local industries benefit fully from better access to EU markets. In this regard one needs to understand how the design of ROOs impacts on the patterns of trade between countries, and what features such rules should have in order to increase their “positive” impact on development.

II. General considerations

ROOs can be classified in two broad categories: preferential and non preferential. Preferential ROOs determine the conditions under which an importing country will consider a given product as “originating” in a given exporting country to which the importing country has granted preferential treatment. Non-preferential ROOs are normally used to make a distinction between domestic and foreign products when implementing trade defense mechanisms such as anti-dumping and countervailing duties and safeguard measures, origin marking requirements, and discriminatory quantitative restrictions or tariff quotas.

As many as 14 GATT obligations (contained in articles I, II, III, VI, IX, XI, XIII, and XIX) require in their application a determination that a given merchandise is imported, as well as an identification of the country of origin.

*) This is the second issue in a series of Policy Notes on Trade initiated by the Research Unit at the Nordic Africa Institute. The purpose of these notes is to set out a baseline assessment of the main issues faced by African countries in the current regional and global trade negotiations. For more information about these Trade Policy Notes and the Global Trade Programme contact the Programme Co-ordinator, Yenkong Ngangjoh Hodu (yenkong.ngangjoh-hodu@nai.uu.se) or the Assistant to the Programme, Tania Berger (tania.berger@nai.uu.se).

In spite of this relevance, there are not detailed indications in the GATT about the substantive criteria to be used to determine the origin of a given product, nor is there yet a “harmonized” definition of the concept.¹

ROOs specify the criteria to be followed in the determination of the national origin of a product, and the treatment (i.e. customs duties and associated non-tariff restrictions) related to the importation of such product. Therefore, preferential ROOs allow governments to discriminate between similar products from different countries, by granting better terms to products originating in a preference-receiving country than to products which originated elsewhere. The latter, normally receive MFN treatment. ROOs are also used in the implementation of a given commercial policy (in matters related to anti-dumping and safeguard measures), in the promotion of foreign investment (and other industrial policy objectives such as local content requirements), in the administration of government procurement contracts, and for labeling and marking requirement purposes. ROOs must follow positive criteria, i.e. they have to clearly indicate what constitutes a substantial transformation.

Trade Deflection

Non-preferential ROOs are designed to curb or minimize trade deflection. Trade deflection occurs when products from a non-EPA Member are transshipped (with minimal processing or assembly) through the territory of a low-tariff EPA Member to a high-tariff one to take advantage of the preferences. In this respect, “substantial transformation” of the product at stake, “value-added”, “cumulation” are some of the concepts used to implement measures to avoid trade deflection.

ROOs can also be used to promote investment in sectors which provide high added value and jobs, since they have the potential to increase local sourcing. Moreover, ROOs may also be used to favor the linkages between industries in a EPA area over those outside of it, in this way providing indirect protection to the EPA-based producers against non-EPA based competitors. In this regard, ROOs can be considered as a tariff on the intermediate product levied by the importing country, and can be used by a member of an EPA to secure the input markets of its EPA partners for the exports of its own intermediate products. For these reasons, ROOs have a strong influence upon trade patterns and the investment flows which are needed to sustain them.

Substantial Transformation

The substantial transformation criterion of the Revised Kyoto Convention is integrated by four basic compo-

nents, which can be used separately or in combination when determining origin. These components are:

- Change in tariff classification between the manufactured good and the inputs coming from non-EPA members that are used in the production process. The transformation of a product may be deemed to be substantial if the end good falls under a different tariff classification of the Harmonized System (HS) from the classification of the intermediate inputs used in its manufacturing. This change of tariff classification can be done at the chapter (2 digits under the HS), heading (4 digits), subheading (6 digits), or item (8-10 digits) levels. There are, however, some problems associated with the use of this particular criterion. For example, headings in certain chapters of the HS do not reflect the degree of processing (e.g. Chapter 1 and live animals); certain processing operations may not be deemed substantial, even though they result in a change in tariff classification (e.g. Chapters 6-14 and chapter 20 for vegetables and fruits, and their freezing, canning in water or natural juices); in various situations a substantial transformation may occur even though there is no change in tariff classification between the inputs and the final product (e.g. chemicals).
- Exceptions relating to a given change in tariff classification prohibiting the use of non-originating materials from certain subheadings, headings or chapters. An example of this is the importation of fresh vegetables and the exportation of frozen ones. The use of exceptions will normally result in protection for certain domestically produced goods within the EPA area.
- Value content requirements (or value added test) which indicate the minimum local value that a given product must acquire in the exporting country. Value added requirements will normally be indicated in minimum domestic or regionally value content, the value of minimum originating parts to be included in the final product, and import content requirements. The general rule under the value added test is that goods obtain originating status in a given exporting country if a specified value was added to the final product in that country.
- Technical requirements indicating a number of manufacturing operations that a given product must undergo in an exporting country in order to obtain originating status. For example, textile products.

Other principles

In addition to the substantial transformation test for specific products, a wider set of principles are also included in most ROOs regimes. These include a de minimis rule indicating the maximum percentage of non-originating materials that can be used without af-

1. For a detailed review of the current state of negotiations for the harmonization of rules of origin at WTO level please refer to <http://www.wto.org>

fecting origin; a roll-up rule which allows for the exclusion of non-originating materials in the calculation of the value added of the subsequent transformation; and cumulation, which allows producers of a given EPA to use materials from another EPA member without losing the preferential treatment for the final product. There are three main types of cumulation: bilateral cumulation, diagonal cumulation, and full cumulation.

To ascertain the degree of efficiency of a given system of ROOs one has to analyze the way in which they are defined and implemented. In this respect supervisory and administrative procedures (i.e. the steps required of commercial agents, the time frame required for the certification of origin, and a quick and clear dispute settlement structure) play a crucial role.

The European Union System of ROOs

The Pan European System (PANEURO) of ROOs is the result of a series of efforts undertaken by the EC in order to harmonize the different ROOs protocols for preferential access that the European Union had put in place with its trading partners. The main motivation behind this harmonization process was to facilitate the operations of EU exporters dealing on, and to allow trading partners to increase their benefits with respect to the preferential treatment being granted through the implementation of diagonal cumulation.

The EU has actively encouraged the widening of the geographical application of the PANEURO system, which it believes plays an important role in the development of trade with its partner countries, as well as in the development of trade between them. Diagonal cumulation is considered to be an essential element in increasing trade between cumulating countries, particularly with respect to the growth of intermediate trade relative to final goods trade, and intermediate imports across sources of supply.

The EC is currently reviewing the PANEURO system. To this end, it produced a Green Paper in 2003 on the future of ROOs in preferential trade agreements to assess problems of origin in preferential arrangements, and other related administrative matter (e.g. systems of verification, declarations of origin and administrative co-operation). Consultations were held from January to March 2004, and in April 2005 a communication on the orientations for the future in preferential trade arrangements was published.

III. Continuing negotiations

The proposal made by the EC to the ACP countries, on April 4th 2007, under the framework of negotiations for an EPA, offers duty-free and quota-free access to the EU market for all ACP originating products, with the exception of sugar and rice, for which a transitional arrangement (i.e. three-phased transitional arrangement for sugar until 2015, and a two year transitional arrangement for rice with a 50% increase in duty free quota access during the transition) is being contemplated.

The EC council endorsed the proposal, at its meeting on May 15th, but instructed the EC to consider in more detail the proposal's impact on the banana sector in order to address some of the concerns of EU Member States. Parallel to this proposal for market access, the EC also started discussions with the six ACP regions on the development of simpler and more development friendly ROOs.

May 25th 2007 the ACP-EC Joint Council of Ministers held an evaluation meeting to assess the current status of EPA negotiations, based on regional reviews for all six EPA regions. The parties reaffirmed their commitment to meet the deadline for concluding the EPA negotiations by the end of 2007 as indicated in the Cotonou Agreement.

In this respect, the EC has also agreed to review its ROOs with the stated purpose of making them simpler, more transparent and easier to administer. Furthermore, the EC has also agreed to help ACP countries to comply with SPS and TBT requirements. The EC has presented a proposal for ROOs based on the value added system as a basis for negotiation, whereas the ACP proposes a market access qualification approach based on the value added criterion or a change in tariff heading, depending on the particular product and the manufacturing process involved. No consensus has been achieved so far between the negotiating parties in this matter.

The ACP countries favor a straightforward change of tariff sub-heading approach, arguing that this methodology is easier for them to implement and imposes lower administrative costs than a value added method. This is an important consideration in light of the impact of the EU's tariff reduction at the multilateral level upon the margin of preferences enjoyed by ACP exporters.

IV. Impact of trade flows

As previously indicated preferential ROOs allow governments to discriminate between similar products from different countries, by granting better terms to products originating in a preference-receiving country than to products which originated elsewhere. In other words, preferential ROOs play a fundamental role in maintaining the existing level of external protection of countries that are parties to an EPA. ROOs can also, depending on the way in which they are formulated, increase that level of external protection, which can result in trade suppression and trade diversion.

The definition and scope of the development dimension to be included in the EPA (as well as the promotion of regional integration) which are stated objectives of the EPA remains at the core of the negotiations between the EC and the ACP. According to a recent study conducted by the South Centre one important element of the development dimension of the EPA is the need to support and strengthen regional economic integration. In this respect, accompanying capacity building measures, as well as trade rules (e.g. "devel-

opment friendly” ROOs) and concessions should aim at facilitating the achievement of these objectives.

In this perspective, the use of restrictive ROOs (particularly in matters related to cumulation) will have an impact on patterns of trade and production mainly in terms of the composition of intermediate usage. Therefore, lack of, or highly restricted rules on cumulation may have a negative impact in the level of trade between countries

The EC acknowledged during the EPA negotiations the need to include support measures in the EPA, but proposes to address these issues not in the text of the EPA itself, but in external instruments such as the European development Fund and the WTO Aid for Trade, and the possible creation of an EPA Regional Fund which will facilitate access to existing aid instruments, and ensure that aid by the EC, the EU Member States and other donors is efficiently and punctually delivered to support the achievement of the EPA objectives.

Harmonized and simplified ROOs will be a very important factor in the consolidation of trade relationships between the EU and the ACP countries which may produce a deeper regional integration and industrialization. Crucial in this respect will be the way in which the concepts of cumulation and value tolerance contained in the EC ROOs are implemented by the EC and, most importantly, whether or not ACP coun-

tries will have the capacity to avail themselves of these possibilities

V. Conclusions

EPAs are very important instruments for encouraging development in ACP countries, and therefore the “development dimension” contained therein should be reflected in the final outcome of negotiations to properly address specific economic and social aspects of ACP countries, and assist them in adapting their economies to the resulting structures of the EPA. Therefore, and to the greatest possible degree, EPAs with ACP countries should take into account regional integration initiatives, and the current degree of preferential access for ACP products.

In this perspective, ACP countries will be better served if the outcome of EPA negotiations result in the adoption of measures to encourage growth mainly through the improvement of trade. The example of East Asia countries provides a good benchmark in this respect.²

2. For a detailed review of these issues see Paul Collie’s excellent book *The Bottom Billion: Why the Poorest Countries are Failing and What Can Be Done About It* (Oxford University Press 2007).

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