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Suggested Rules of Origin Regime for EAFTA

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Suggested Rules of Origin Regime for EAFTA

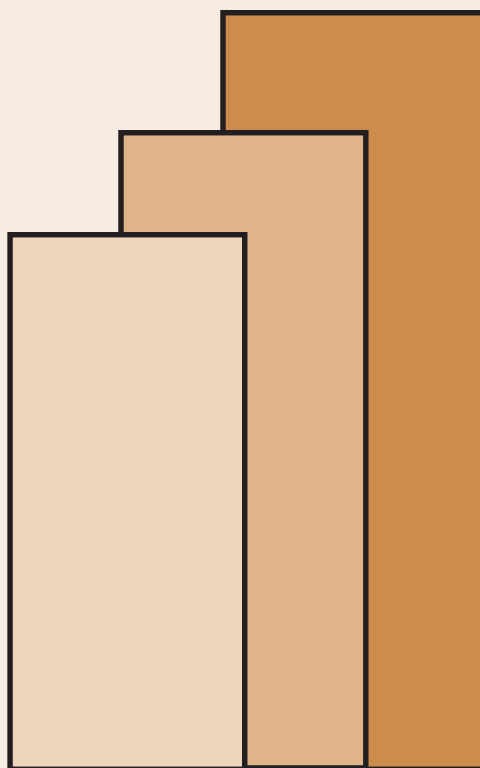
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Suggested Rules of Origin Regime for EAFTA

Erlinda M. Medalla and M. Supperamaniam

Abstract

Determining origin within the context of international trade is not simple. Rules of Origin (ROOs) would involve laws, regulations and administrative determinations to ascertain a product's country of origin which are not costless to comply with. As such, the criteria used to define 'origin' and how it is administered would play a crucial role in the global trading order.

In moving toward the East Asian vision of a community, a rational, enabling regime of ROO that would encourage deeper economic integration and shared prosperity should be established. This means a set of ROOs that is trade facilitating even as it attempts to prevent trade deflection, with enough safeguards for inclusive development both within and across countries in the region.

To provide a clear understanding of the ROO and their proper application, this paper discusses the various approaches in determining the rules of origin. It also looks at the different ROO regimes in East Asia then points out some of the recurring ROO issues. Finally, the paper suggests key features of the ROO for the effective implementation and success of any preferential agreement such as the EAFTA.

Keywords: rules of origin, preferential trading agreements (PTAs), free trade agreements (FTAs), regional trade agreements (RTAs), East Asia

Suggested Rules of Origin Regime for EAFTA^o

*Erlinda M. Medalla** and *M. Supperamaniam***

1. INTRODUCTION

Many issues surround the Rules of Origin (ROOs) which are becoming very much a part of the global trading system. *First*, the globalization of production and processes has made origin determination increasingly difficult and dispute prone. Few products today are made solely in one country, vastly enabled by the increasingly globalized nature of international trade and finance. *Second*, ROOs have both trade and investment impacts, as they affect not only trade preference but sourcing of inputs and, thereby, investment and production decisions. *Third*, there is opportunity to make use of ROOs as protectionist tool *per se*. A free trade agreement might have been forged at the outset by trading partners to bring down barriers between them, but protectionist tendencies are difficult to completely stamp and ignore. In those instances, the ROO can be used as a discriminatory trade policy tool to protect ‘preferred’ domestic sectors. *Fourth*, the various plurilateral and bilateral free trade agreements (FTAs) give rise to the so-called noodle bowl effect of a complex and possibly inconsistent web of ROOs, product standards and conformance requirements and diverse tariff liberalization schedules. Determining and proving the ‘nationality’ of traded products under various international trading rules could entail significant costs on the part of both government and business. (Lazaro and Medalla, 2006) These concerns are well recognized, as manifested in the numerous studies and discussions covering the related issues, especially in recent years.

Nonetheless, despite of all the surrounding issues, a regime of ROOs is a necessary feature of any RTA. Otherwise, “trade deflection” (the trans-shipment of products from non-members to FTA-members through a low-tariff FTA partner) could occur and the trade preference offered by the FTA is eroded. The ROO regime attempts to prevent trade deflection by imposing criteria that ensures an adequate degree of transformation in a preference-receiving country to justify allowing the good to benefit from the preference.

The ROO provision under a particular agreement is a product of detailed negotiations during its formation. As a result, there are no internationally set and harmonized rules on the form of ROO in FTAs. They vary in their nature and complexity, and can have specific elements of protectionism as well as inducements for deepening trade relations.

^o This paper draws heavily from Medalla (2008) a paper submitted to ERIA, Lazaro and Medalla (2006) and a forthcoming paper on ASEAN ROO the first author is preparing for ERIA.

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In moving toward the East Asian vision of a community, it is necessary to establish a rational, enabling regime of ROOs that would encourage deeper economic integration and shared prosperity. This means a set of ROOs that is trade facilitating even as it attempts to prevent trade deflection, with enough safeguards for inclusive development both within and across countries in the region. This paper is an attempt to determine what such a regime of ROOs should be.

A clear understanding of the ROOs and of their proper application is of utmost importance for the effective implementation and success of any preferential agreement. As such, this paper first examines the general approaches to ROOs. Then, the paper provides an inventory and comparison of ROO regimes in East Asia, followed by a discussion on what have been the recurring issues surrounding ROOs. The paper concludes with recommendations for ROOs under a possible East Asia Free Trade Agreement (EAFTA).

2. DETERMINING ORIGIN

ROOs refer to specific provisions that are established in international trading agreements to determine the origin of goods being traded. In effect, similar imported goods are treated differently depending upon which country the product is made.

In general, there are three (3) basic elements that factor into the setting of ROOs.

- a) First is the distinction between wholly obtained and non-wholly obtained goods.
 - a product is deemed as originating from a particular country if it contains no materials or processing from outside that country (wholly obtained goods)
 - non-wholly obtained goods can also be deemed originating from the particular country if “sufficient working or processing” or substantial transformation has taken place.

- b) For non-wholly obtained goods, sufficient working or processing is in turn determined on the basis of any (or combination) of the following basic criteria:
 - a change in tariff classification (CTC) rule,
 - on the basis of a minimum value added and/or maximum allowable value of intermediate imports as a percentage of the value of the final product or
 - on the basis of conforming to specific production processes.

- c) In turn, allowable intermediate imports could involve:
 - Maximum allowable imports from non-partners to the agreement (as a *de minimis* rule), and
 - Some form of cumulation of inputs (value-added) from partners within the agreement.

For example, the ROO provisions in ASEAN Free Trade Agreement (AFTA) categorizes first between Wholly Produced or Obtained and Not Wholly Produced or Obtained products, then spells out conditions for Not Wholly Produced goods, generally using a minimum regional (cumulation) value added criteria of 40 percent.

‘Wholly obtained’ criteria would apply to goods that are clearly produced domestically. These are more easily identified and have clear HS (Harmonized System) nomenclature and coding. They are mainly in the first 20 HS chapters covering mining, live animals, fruits, with some processing.

For non-wholly obtained products, there are several approaches to defining whether ‘substantial’ transformation has occurred to satisfy originating criteria. In general, these include three major methods, used singly or in combination—the *value-added measure (VA)*, the *tariff heading criterion (CTH)*, and the *specified processes (SP) test*.

The VA test, simply put, requires a product to have a specified minimum percentage of value added created at the last stage of the production process (also the *domestic content test*). The VA test is apparently simple and precise but it can be very costly to comply with. Proving a value-added content could be subject to differences in calculation method, fluctuation in values, among other concerns. There would be costs in tracing the inputs, and a manufacturer of a complex product would need a highly sophisticated inventory and accounting system. (La Nasa 1995)

The *tariff-heading criterion*, also referred to as change in tariff classification (CTC), is a rule which confers origin if the activity in the exporting country results in a product to be classified under a different heading of the customs tariff classification from its main intermediate input. This criterion is comparatively simple and predictable, and indeed, it is increasingly resorted to in more recent FTAs (and ROO refinements in older FTAs). Its limitation is that trade classification systems have not been designed with the objective of distinguishing substantial transformation.¹ As such, a question that arises, for example, is what level of disaggregation should the change be determined for “substantial transformation” criteria to be satisfied.

The *specified processes* or *technical test* determines, on a case-by-case basis, specific production activities or specific processing operations that may confer originating status. This prescribes certain production or sourcing processes that may (positive test) or may not (negative test) confer originating status. (UNCTAD 2002) An example is the so-called *yarn forward* (sometimes triple transformation) rule for textile and garment products. The

¹ While the Harmonized System reflects the most sophisticated and refined tariff classification system, it is primarily designed for the dual purposes of commodity classification and compilation of statistics. (La Nasa 1995)

obvious limitation of this test is the rigidity and difficulty of defining a process test for an unending list of products, which need to be continuously updated with corresponding new rules for new products and processes arising from new technologies. The process involved is also susceptible to industry lobbying groups during negotiations (and drafting of rules), because drafters and administrators would have to rely on the industry for information. (La Nasa 1995) Lastly, for negative technical tests, the criterion specifies only which processes do not confer origin and thus, could leave a large gray area, making the particular ROO very restrictive.

The adoption or rejection of particular criteria of substantial transformation as a method of determining origin generally depends on which principle one puts more value on: *flexibility* or *certainty*. Having flexibility in the set of ROOs which allows for evolution over time, adaptive to the need for changes and other developments, would have obvious advantages for member parties. On the other hand there are potential disadvantages in being too flexible, e. g., inconsistent applications, discretionary nature and the costs of making an origin determination under it.

The advantages, disadvantages and key issues using the different methods are highlighted in Table 1 below as summarized by Brenton (2003).

Table 1: Summary of the Different Approaches to Determining Origin

Rule	Advantages	Disadvantages	Key Issues
Change of Tariff Classification (in the Harmonised System)	<ul style="list-style-type: none"> ● Consistency with non-preferential rules of origin. ● Once defined, the rule is clear, unambiguous and easy to learn. ● Relatively straightforward to implement. 	<ul style="list-style-type: none"> ● Harmonized System not designed for conferring origin, as a result there are often many individual product specific rules, which can be influenced by domestic industries ● Documentary requirements maybe difficult to comply with. ● Can be conflicts over the classification of goods which can introduce uncertainty over market access 	<ul style="list-style-type: none"> ● Level of classification at which change required – the higher the level the more restrictive. ● Can be positive (which imported inputs can be used) or negative (defining cases where change of classification will not confer origin) test^a – negative test more restrictive.
Value Added	<ul style="list-style-type: none"> ● Clear, simple to specify and unambiguous. ● Allows for general rather than product specific rules 	<ul style="list-style-type: none"> ● Complex to apply – requires firms to have sophisticated accounting systems. ● Uncertainty due to sensitivity to changes in exchange rates, wages, commodity prices etc. 	<ul style="list-style-type: none"> ● The level of value added required to confer origin ● The valuation method for imported materials – methods which assign a higher value (eg CIF) will be more restrictive on the use of imported inputs
Specific Manufacturing Process	<ul style="list-style-type: none"> ● Once defined, clear and unambiguous ● Provides for certainty if rules can be complied with 	<ul style="list-style-type: none"> ● Documentary requirements can be burdensome and difficult to comply with. Leads to product specific rules. ● Domestic industries can influence the specification of the rules. 	<ul style="list-style-type: none"> ● The formulation of the specific processes required – the more procedures required the more restrictive ● Should test be negative (processes or inputs which cannot be used) or a positive test (what can be used) – negative test more restrictive.

Source: Notes on Rules of Origin with Implications for Regional Integration in South East Asia by Paul Brenton, 2003

There are other tests utilized for different types of products. Some FTAs also apply so-called “hybrid tests” which require both a minimum percentage of domestic value-added content *plus* a change in tariff classification for a product to undergo a “substantial transformation.” (Coyle 2004). On the other hand there is the more liberal either/or test, which provides a choice about which rule to use (alternative or co-equal rule). Given that there are no internationally agreed standards, an importing country can vary rules of origin according to its trading partners and products.

Additional typical features of ROOs are also utilized to simplify or refine the process of conferring origin. Examples of these are provisions allowing a certain degree of *de minimis*, the roll-up principle and various types of cumulation. The *de minimis rule* allows for a specified maximum percentage of non-originating materials to be used without affecting origin. *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. (Estevadeordal and Suominen 2003) Finally, cumulation (also known as *accumulation*) is a measure that permits countries to use inputs from a specific country or group of countries without affecting the origin of the products. In essence, cumulation provisions permit inputs to be obtained from *outside* the FTA and be counted as *domestic* for the purposes of determining the origin of the product. (Coyle 2004)

There is a growing trend in the use of the cumulation² type of ROO-- in particular, the *diagonal cumulation* which expands the geographical and product coverage of an ROO regime in FTAs. The traditional interpretation of this diagonal cumulation is to permit three or more countries to effectively merge their individual bilateral treaties into a single comprehensive FTA in which inputs can be sourced anywhere within the network. They can also allow even a non-party country to the agreement to be included in the cumulation process. A prime example is the US-Singapore Integrated Sourcing Initiative.

Varying degrees of restrictiveness in types of ROOs

Depending on how these approaches are implemented, the ROO regime could result in varying degrees of restrictiveness. In general, some would argue that using a single rule makes it simple. However, the single rule could be difficult to comply with depending on the single rule adopted. In general, the most liberal would be the using alternative rules (also referred to co-equal rules) where an exporter is allowed to choose among different rules of claiming origin. At the other

² There are three types of cumulation. *Bilateral cumulation* operates between the two FTA partners and permits them to use products that originate in the other FTA partner as if they were their own when seeking to qualify for preferential treatment. *Diagonal cumulation* means that countries tied by the same set of preferential origin rules can use products that originate in any part of the area as if they originated in the exporting country. *Full cumulation* provides that countries tied by the same set of preferential origin rules among each other can use goods produced in any part of the area, even if these were not originating products. (Estevadeordal and Suominen 2003)

extreme, generally considered most restrictive, would be having to comply with more than one rule (plus rather than either/or), for example, both a CTC and VA rule.

The more applicable the cumulation principle, the more liberal (and less restrictive) the ROO would be. This is especially true if the VA rule is used in tandem with the roll-up or absorption principle. In ASEAN for example, the AFTA ROO allows so-called partial cumulation (which is essentially full cumulation) of intermediate inputs from other ASEAN members which has passed the VA criteria. In addition, cumulation is for the full value of the intermediate input (hence the term full cumulation), and not just the local value added.

How the *de minimis* principle is used in the agreement would greatly affect how liberal the ROO provision of the FTA. Most existing FTAs use the provision sparingly as a product specific rule. In general, the more extensive the *de minimis* rule is applicable, the more liberal the ROO regime would be. Also, the cut-off rate (the *de minimis* level) tends to be low in many existing FTAs. The lower the cut-off rate, the more restrictive the ROO regime would be.

Another general indicator of restrictiveness is the cut-off level used in the case of the VA rule. The lower the value-added percentage requirement, the more liberal the ROO is. In the case of the CTC rule, the higher the level of aggregation (classification) required for a change, the more restrictive the ROO, and conversely. In addition, the use of the negative test (*i. e.*, excluding certain classifications where change cannot come from) would make it more restrictive.

Sensitive Sectors in ROOs

It is mainly with respect to sectors like textiles and clothing, iron and steel, and automotive products which are most especially sensitive to the type of ROO adopted. These are the sectors usually accorded higher tariff (and often also non-tariff) protection, leading to concerns of protectionist capture in the design of the ROO. (OECD 2002) Ironically, or maybe not, these sectors are also where the FTA would have highest impact. The ROO is especially relevant in the case of textiles and clothing given the elimination of quota allocation in the Multi-Fibre Arrangement (MFA).

NAFTA's ROO regime is particularly complex and the most complicated rules apply to special cases, including the so-called "maquiladoras"³ and the special regime covering textiles and clothing. The basic rules are so-called "yarn forward" and "fiber forward" rules according to which textiles and clothing products are deemed originating provided they are made of yarn or fiber produced in the area which would include all the cutting and sewing. (Krueger 1993) Apparel products imported into the US must satisfy a "triple transformation" rule requiring domestic content at each one of three transformation stages: *fiber to yarn, yarn to fabric* and

³ *Maquiladoras* is a term referring to production units doing offshore assembly work for the US market. Generally, they are US owned companies enjoying preferential tariff treatment in the US before and even during the early years that NAFTA was formed. (Cadot et al 2002)

fabric to garment. (Cadot et al2002) An examination of US ROOs would contain these rules although there are some 3rd country allowances to countries like Israel, Morocco and Jordan.

The next section looks at the different ROO regimes in East Asia. This would provide an idea about the initial conditions in the region.

3. INVENTORY AND COMPARISON OF ROO REGIMES IN EAST ASIA RTAS

ASEAN represents the largest grouping involving the East Asian countries. In addition, most of the other arrangements in East Asia would revolve around ASEAN, such as the “ASEAN+1” agreements namely the ASEAN-China agreement, ASEAN-South Korea, and ASEAN and Japan; and as the East-Asia-wide initiative under the “ASEAN Plus Three” (APT) mechanism.

In the case of bilateral agreements among East Asian countries, the most prominent are the various bilateral economic partnership agreement (EPA) being forged by Japan with individual ASEAN country, in parallel with its ASEAN-Japan track. This includes five which have been concluded and in force (with Singapore, Malaysia, Thailand, Indonesia and Brunei). The Japan-Philippine EPA has been signed but as yet to be ratified by the Philippine Senate and Japan’s EPA with Vietnam is in the process.

➤ ASEAN (AFTA) ROO

The main AFTA provision on ROOs states that :

- (i) A product shall be deemed to be originating from ASEAN Member States, if at least 40 percent of its content originates from any Member States;*
- (ii) Locally-procured materials produced by established licensed manufacturers, in compliance with domestic regulations, will be deemed to have fulfilled the CEPT origin requirement; locally-procured materials from other sources will be subjected to the CEPT test for the purpose of origin determination;*

As observed by Estevadeordal and Suominen (2003), the AFTA ROO is prominent for its generality in application, originally utilizing just the single method of value-added criterion. It provides for 40 percent regional value added content (RVA) to qualify as originating good for non-wholly produced or obtained goods. At least on paper, the rule is simple and relatively generous provision for imported inputs. The main reason for this is the reliance of most member countries on electronics and textile and garments for their exports, products produced within GPNs accounting for low value-added/local content, such that even 40 percent value added (VA) may be too high.

ASEAN is also further refining its cumulation rule and developing a “partial” cumulation approach-- that is, even goods of “partial” origin not having satisfied the 40 percent threshold can be cumulated as part of RVA. The practice in ASEAN is to count “components as part of

ASEAN content which themselves have ASEAN content of 40 percent or more.” ASEAN has now agreed to the percentage content requirement reduced to 20 percent of ASEAN content.

This move is envisioned to help most developing ASEAN member countries, whose sources of inputs, given the GPN structure would come from outside the region. Some estimates show that in most ASEAN countries, for major manufactured exports (e. g. textile, garments and electronics) total ASEAN content is less than 20 percent . (Manchin and Pelkmanns-Balaoing, 2007)

Hence, in general, reforms to simplify the ROO are continuously being sought. However, there are no provisions as yet for the treatment of duty drawback or the Absorption or Roll Back principle.

Recently, ASEAN has also adopted the substantial transformation rule (i.e. change in tariff heading as an alternative criterion to the general value added rule to keep pace with the changing global and regional environment, ASEAN currently has substantial transformation rules for wheat, flour, aluminum, products, iron and steel products, textile and clothing, electronics, as well as rubber and wood based products.

JETRO (2004) on ASEAN’s FTAs and Rules of Origin reports some improvement in the share of CEPT exports. It noted that the share of CEPT exports to total ASEAN exports more than doubled from 10.8 percent in 2002 to 22.5 percent in 2003. This likely indicates better utilization of the CEPT preference. This could also indicate that reforms undertaken do matter.

➤ ASEAN + 1 ROO

In addition to the ASEAN Free Trade Area, ASEAN as a whole is also engaged with various Dialogue Partners to implement or discuss free trade areas under the “ASEAN plus” framework. Agreements have been signed with China (ACFTA), Korea (AKFTA), and Japan (AJCEP).

All the three ASEAN + 1 FTAs (ACFTA, AKFTA and AJCEP) adopt the general 40 percent local/regional value added (RVA) rule, with full cumulation. They also provide for alternative rule using CTC for certain products. ACFTA is more similar to AFTA during its early stage, using mostly the single RVC rule, with some exceptions. AKFTA is the most liberal in terms of number of lines with alternative rules. For the AJCEP, the general rule is CTC, with the more frequent adoption of RVA as an optional rule. This reflects the trend towards more liberal ROO regime for Japan, whose ROOs in earlier FTAs (JSEPA, for example) tended to be relatively more restrictive. The progression for AFTA and ASEAN plus one, thus far, has been towards more flexibility (and thus less restrictiveness).

Reforms in the AFTA ROO introduced more flexibility, covering a larger number of products with alternative CTC rule. These include 424 (HS6) textile and textile products items, 2 items of preserved fish, 6 items of wool, 22 of leather goods, 14 for furskins and 4 item lines of footwear. The AKFTA appears even more liberal with even larger product coverage allowed to use CTC as an alternative rule (except for a few cases in the automotive sector where the RVA requirement

is 45 percent). It even introduces the novel approach of back-to-back Certificate of Origin (CO) for re-exports of partner A into partner B of products which was first exported by partner C into A, e.g. transit exports of Singapore from another ASEAN country. (Manchin and Pelkmans-Balaoing, 2007)

The ASEAN secretariat provides detailed information on ROO by product at the eight digit level for AFTA-CEPT and AFTA + 1. Table 2 below summarizes the frequency by ROO type for ASEAN, AKFTA, ACFTA and AJCEP. It indicates, as noted above, that AFTA is generally liberal, with the AKFTA appearing to be the most liberal, based on the more frequent use of co-equal rules (change in tariff heading-CTH or regional value content-RVC). This, however, should not be considered strict comparison, with each agreement having its own advantages over others in terms of liberality. AFTA, for example, although having fewer (CTH or RVC) counts, have the highest number of (CTSH or RVC). CTSH is Change in Tariff Subheading, which is at 6-digit level of classification compared to CTH at four-digit level. (CC is the most restrictive, requiring a change in a higher level of commodity classification). As with AFTA, ACFTA started using 'RVC(40) only' for almost all lines but has made reforms in recent years to introduce more flexibility, especially in textile products. The important observation is the trend towards a more liberal ROO regime in East Asia, which bodes well for the achievement of a best-practice East Asia ROO.

Table 2. FTA by Type of ROO (2007): AFTA, AKFTA, ACFTA & AJCEP

ROO type	AFTA	AKFTA	ACFTA	AJCEP
WO	169	465	8	3
CC		61	1	1344
CTH		2		434
CTSH				8
RVC(>40)		36		
RVC(40)	146	22	4659	219
RVC(<40)		2		
CC + RVC(40)		2		1
CTH + RVC		4		
CC or RVC(40)	564	487	7	126
CTH or RVC(>40)		4		
CTH or RVC(40)	2583	4078	122	3056
CTSH or RVC(40)	689	61		33
RVC(40) or Textile Rule			427	
CC or RVC(40) or Textile Rule	300			
CTH or RVC(40) or Textile Rule	327			
NA*	446			
total	5224	5224	5224	5224

*no available entry; WO- wholly obtained; CC- change in commodity classification; CTH- change in tariff heading; CTSH- change in tariff subheading; RVC- regional value content

Source: Forthcoming paper by the first author for ERIA on ASEAN ROO.

Source of basic data: ASEAN Secretariat (Courtesy of Ms. Anna Robeniol)

➤ Bilateral FTAs among East Asian countries

Among the northeast countries (China, Japan and Korea), Japan has been the most active in pursuing bilateral agreements with other East Asian countries, specifically ASEAN-6 and Vietnam.⁴ Its strategy is to follow a dual track approach of forging bilateral partnership with individual ASEAN country along side negotiating an agreement with ASEAN as a group. A number of reasons have been cited, including the most practical one of threshing out first the details and difficult areas with specific countries, which would pave the way for a smoother implementation of an ASEAN-Japan partnership. The bilateral agreements forged by Japan with individual ASEAN countries are intended to be incorporated (as annexes) in the ASEAN-Japan Comprehensive Economic Partnership (AJCEP). If individual EPAs are not completed by the time AJCEP is concluded, the ROO will not be open to renegotiation.

The advantage of the dual track approach of Japan is the opportunity for one country to demand more flexible terms from Japan than what would otherwise happen in negotiating as a group. However, this is also a disadvantage since in all probability, a non-uniform outcome per industry across country would result, which would make consolidation difficult later on. While ACFTA and AKFTA are in essence also a series of bilateral agreements, with each country having bilateral negotiations with China and Korea in terms of preferences, at least, the ROO regime would be uniform per product. And as it turns out (as earlier discussed), what has emerged is even more liberal ROO regime than AFTA.

In examining Japan's bilateral with individual ASEAN countries, the trend is similar, although generally more restrictive. The earliest of Japan's EPA, that with Singapore, is indeed generally more restrictive than the newer EPAs of Japan. JSEPA (Japan-Singapore EPA) is characterized by particularly complex ROO especially for agricultural products, textiles and apparel. (Manchin and Pelkmans-Balaoing, 2007). Majority uses mainly the change of tariff heading rule defined for specific products. Alternative RVC rule is allowed for a few products but at a high rate of 60 percent and where it is lower than 40 percent, the RVA rule is an additional rule. However, Singapore and to a lesser extent Japan, already have duty-free MFN status so that the ROO regime (and for that matter, the preferential treatment) is almost immaterial. *De minimis* is also provided for, but as a product specific rule.

Japan's more recent EPA has less restrictive ROO compared to JSEPA. The general rule is the CTC approach, defined for specific products, but in many cases, an alternative VA rule of 40 percent as in AFTA is used. As in JSEPA, there is provision for *de minimis*, but as a product specific rule.

⁴ Singapore and Thailand are of course more prolific, starting much earlier on in their pursuit of bilateral agreements, but Japan has been the more active with respect to forging partnerships with other East Asian countries, as Singapore and Thailand are already being a member of ASEAN.

Kawai and Wignaraja (2007) provide an overview of the main ROOs adopted by 30 concluded FTAs in East Asia. Their summary table is reproduced here as Table 2 below. Their study notes that majority of FTAs in East Asia (20) have adopted a combination of the three ROOs rather than applying a single rule. The AFTA and the ACFTA use what they consider the simplest ROO—largely the VA rule, which specifies a 40 percent regional value content across all tariffs. They observe that the developed countries in East Asia, namely Japan, Korea and Singapore, tend to use a combination of ROOs, adding to the complexity and costs for business.

With respect to types of products, they provide some additional insights. For example, they note some variation in the case of major automotive and automotive parts in 11 major concluded FTAs (see Tables 4a & 4b- lifted from Table 10 of Kawai and Wignaraja, 2007). The VA rule is generally 40 percent for AFTA and ASEAN-China, but higher for ASEAN-Korea at 45 percent. The VA criterion is 60 percent in Japan-Malaysia for HS8703 and 8711 in contrast with 40 percent in Japan-Thailand FTA for the same two products. There are similar instances in the case of Singapore-Australia FTA and Thailand-Australia FTA.

In general, however, the ROOs for AFTA and ASEAN+1 FTAs are less restrictive even in the normally sensitive sectors. Tables 5a to 5c, for example, provide some information on the ROO for iron and steel, textile, garments, and food and agricultural products. The RVC (regional value content, also referred to in this paper as regional value added or RVA) requirement is generally 40 percent. Moreover, co-equal rules are usually allowed.

The few exceptions of RVC greater than 40 percent are for 7 tariff lines for food and agricultural products in the case of AKFTA (out of 729 in this group of commodities). AKFTA, however, has more than two thirds of the HS lines in this grouping considered wholly-obtained (at 427 HS lines), far more liberal, even compared with AFTA (at 129 HS lines). This is in stark contrast with ACFTA using almost solely the RV(40) rule, and AJCEP using mainly change in classification. See Table 5c.

For textile and textile products, AFTA and AKFTA appear less restrictive, with majority of HS lines using co-equal rules, with AFTA slightly ahead, using a lower level of classification for more products. ACFTA uses ‘RVC only’ for majority of lines, while Japan is most restrictive, using just change of classification, many of which are at high level of classification (CC). See Table 5a.

For iron and steel, Japan and China tend to use more of the RVC rule of 40 percent, while AFTA and AKFTA tend to use more of the co-equal rule of ‘RVC (40) or CTC’, making the latter more liberal. See Table 5b.

In sum, some key observations can be gleaned from examining the ROO regimes in the various FTAs in East Asia:

- Significant variance exists among ROO provisions. ROO complexity and costs are compounded across multiple FTAs or within overlapping agreements.

- The AFTA has a relatively simple and liberal ROO provision of AFTA, characterized by generality in application. In addition, reforms being sought lean towards more liberal rules by “expanding/easing standards.”
- The existing FTAs in East Asia (limited to those which involve only the 13 East Asian countries) are more or less consistent with AFTA ROO, with the use of 40 percent RVA. AKFTA appears to be generally the least restrictive.
- Most sensitive sectors for most countries include automotive, textile and garments sectors. In addition, various rules are applied across countries and across specific commodity classifications.
- There is increasing use of CTC as an alternative rule, being defined for specific products.
- Even Japan, with a greater tendency in the past to have restrictive ROO have become more liberal, using alternate rules for majority of cases in the recent AJCEP.
- ACFTA, on the other hand can be considered simpler, using only RVC (40) in the majority of cases. However, the lack of alternative rule could be constraining. Reforms are being made to accommodate greater flexibility with more alternate rules being developed.
- However, in general, there is a trend towards progressively more liberal ROO regime in East Asia.

Table 3. Rules of Origin of Concluded FTA's in East Asia, 2007

Agreement	Compared with AFTA (40%) VA rule
Value-Added Rule (VA) only (3 FTAs)	
1 Singapore-New Zealand Closer Economic Partnership Agreement (2001)	consistent
2 Singapore-Australia Free Trade Agreement (2003)	some products more/less restrictive
3 Singapore-Jordan Free Trade Agreement (2005)	less restrictive
VA and/or Change of Tariff Classification (CTC) Rules (3 FTAs)	
1 Taipei, China-Panama Free Trade Agreement (2004)	some products more/less restrictive
2 Thailand-New Zealand Closer Economic Partnership Agreement (2005)	more restrictive
3 PRC-Chile Free Trade Agreement (2006)	some products more restrictive
VA and/or Specific Product Rules (4 FTAs)	
1 Asia-Pacific Trade Agreement (1976)	more restrictive
2 ASEAN Free Trade Agreement (1993)	consistent
3 ASEAN-PRC Free Trade Agreement (2005)	consistent
4 PRC-Pakistan Free Trade Agreement (2006)	consistent
Combination of all Rules (VA, CTC, SP, others) (20 FTAs)	
1 Singapore-European Free Trade Association (EFTA) Free Trade Agreement (2001)	some products more restrictive
2 Japan-Singapore Economic Agreement for a New-Age Partnership (2002)	more restrictive
3 Korea-Chile Free Trade Agreement (2004)	some products more/less restrictive
4 PRC-Hongkong, China Closer Economic Partnership Arrangement (2004)	less restrictive
5 PRC-Macao Closer Economic Partnership Arrangement (2004)	less restrictive
6 Singapore-United States Free Trade Agreement (2004)	some products more/less restrictive
7 Korea-European Free Trade Association (EFTA) Free Trade Agreement (2005)	some products more/less restrictive
8 Singapore-India Comprehensive Economic Cooperation Agreement (2005)	consistent
9 Japan-Mexico Economic Partnership Agreement (2005)	more restrictive
10 Thailand-Australia Free Trade Agreement (2005)	some products more restrictive
11 ASEAN-Korea Free Trade Agreement (2006)	some products more restrictive
12 Japan-Malaysia Economic Partnership Agreement (2006)	consistent
13 Japan-Philippines Economic Partnership Agreement (2008)	consistent
14 Trans-Pacific Strategic Economic Partnership Agreement (2006)	more restrictive
15 Singapore-Panama Free Trade Agreement (2006)	less restrictive
16 Korea-Singapore Free Trade Agreement (2006)	more restrictive
17 Japan-Thailand Economic Partnership Agreement (2007)	consistent
19 Japan-Brunei Economic Partnership Agreement (2007)	consistent
20 Korea-United States Free Trade Agreement (2007)	some products more/less restrictive

Source: Drawn from Table 9 in Kawai and Wignaraja, 2007. ASEAN+3 or ASEAN+6: Which Way Forward

Notes: consistent- in comparison with AFTA 40% VA criteria

More restrictive – more than 40% VA required

Less restrictive – less than 40 % VA required

Table 4a. Rules of Origin for Major Auto and Auto Parts Products- AFTA, ACFTA, AKFTA.

FTA		AFTA	ACFTA	AKFTA
HS Code	Product Description			
87.01	Tractors (other than works, warehouse equipment)	RVC of not less than 40%*	RVC of not less than 40%*	RVC of not less than 40%
87.03	Motor vehicles for transport of persons (except buses)	RVC of not less than 40%*	RVC of not less than 40%*	RVC of 45%
87.04	Motor vehicles for the transport of goods	RVC of not less than 40%* 40%*	RVC of not less than 40%* 40%*	RVC of 45%
87.08	Parts and accessories for motor vehicles	RVC of not less than 40%*	RVC of not less than 40%*	RVC of 45%
87.11	Motorcycles, bicycles, etc. with auxiliary motor	RVC of not less than 40%*	RVC of not less than 40%*	RVC of not less than 40%
87.14	Parts and accessories of bicycles, motorcycles, etc.	RVC of not less than 40%*	RVC of not less than 40%*	or a CTH (4 digits)* RVC of not less than 40% or a CTH (4 digits)*

Notes: The general rules of origin of the FTA are adopted when there is no Specific Product (SP) rule provided. CTH=Change of Tariff Headings; RVC=Regional Value Content; VC= Value Content.

Source: lifted from Table 10 in Kawaiand Wignaraja, 2007. ASEAN+3 or ASEAN+6: *Whi8ch Way Forward*

Table 4b. Rules of Origin for Major Auto and Auto Parts Products in Selected East Asian Bilateral FTAs

FTA		JAPAN Japan- Malaysia EPA(2006)	JAPAN Japan- Singapore EPA (2002)	JAPAN Japan- Thailand EPA (2007)	KOREA Korea- Singapore FTA (2006)	SINGAPORE Singapore Australia FTA (2003)	SINGAPORE Singapore United States FTA(2004)	THAILAND Thailand- Australia FTA (2005)
HS Code	Product Description							
87.01	Tractors (other than works warehouse equipment)	CTH (6 digit) or RVC of 40%	CTH; last substantial manufacture*	CTH or RVC of 40%	CTH plus RVC of 55%	VC of not less than 50%*	CTH plus RVC of at least 30% (build up)	CTH plus RVC of 40%
87.03	Motor vehicles for transport of Persons (except Buses)	CTH or RVC of 60%	CTH; last substantial manufacture*	CTH or RVC of 40%	CTH plus RVC of 55%	Last process of manufacture w/in territory of the party	CTH plus RVC of at least 30% (build up)	CTH plus RVC of 40%
87.04	Motor vehicles for the transport goods	CTH or RVC of 50%	CTH; last substantial manufacture*	CTH or RVC of 40%	CTH plus RVC of 55%	VC of not less than 50%*	CTH plus RVC of at least 30% (build up)	CTH plus RVC of 40%
87.08	Parts and accessories for motor vehicles		CTH; last substantial manufacture*	CTH or RVC of 40%	CTH plus RVC of 50%/55%	Last process of manufacture within territory of the party	CTH (6 digit) or CTH plus RVC of at least 30% (build up)	CTH (6 digit) plus RVC of 40%
87.11	Motorcycles, bicycles, etc with auxiliary motor	CTH or RVC of 60%	CTH; last substantial manufacture*	CTH or RVC of 40%	CTH plus RVC of 55%	VC of not less than 50%*	CTH (4 digit) or CTH plus RVC of at least 30% (build up)	CTH (6 digit) and/or RVC of 40%
87.14	Parts and accessories of bicycles, motorcycles, etc	CTH or RVC of 40%	CTH; last substantial manufacture*	CTH or RVC of 40%	CTC (4 digit)	VC of not less than 50%*	CTH (6 digit) or CTH plus RVC of at least 30% (build up)	CTH (6 digit)

Notes: The general rules of origin of the FTA are adopted when there is no Specific Product (SP) rule provided. CTH=Change of Tariff Headings; RVC=Regional Value Content; VC= Value Content.

Source: lifted from Table 10 in Kawai and Wignaraja, 2007. ASEAN+3 or ASEAN+6: Which Way Forward

**Table 5a. ROO frequency by type: Textile and Textile Products
Chapters 50-60**

	HS lines
CEPT PSR for 2007 ROO	
RVC(40) or CC	26
RVC(40) or CC or Textile Rule	83
RVC(40) or Textile Rule or CC	44
RVC(40) or CC or Textile Process Rule	30
RVC(40) or CTH (GR)	2
RVC(40) or Textile Rule or CTH	324
no entries (i.e.#N/A)	45
Grand Total	554
AKFTA	
CC or RVC(40)	209
CTH with exceptions for certain tariff headings	8
CTH or Printing or dyeing accompanied by at least two preparatory or finishing operations or RVC(40)	18
CTH or RVC(40)	93
CTH or RVC(40) (GR)	226
Grand Total	554
ACFTA	
Obtained from sheep, lambs or other animals raised in ACFTA	6
RVC(40) or Textile Rule	135
RVC(40)(GR)	413
Grand Total	554
AJCEP (Nov 07)	
CC	71
CC, with exceptions for certain tariff headings	120
CC, with specific conditions	60
CTH	4
CTH, with exceptions for certain tariff headings	6
CTH, outside specified subheadings & with specific conditions	290
CTH, with specific conditions	3
Grand Total	554

Source: Forthcoming paper by the first author for ERIA on ASEAN ROO.
Source of basic data: ASEAN Secretariat, courtesy of Ms. Anna Robeniol

Table 5b. ROO frequency by type: Iron and Steel Chapters 72-73	
CEPT PSR for 2007 ROO	HS lines
RVC(40)	50
RVC(40) or CC	32
RVC(40) or CC with exceptions for certain tariff headings	66
RVC(40) or CTH (GR)	83
RVC(40) or CTH with exceptions for certain tariff headings	42
RVC(40) or CTSH	6
no entries (i.e.#N/A)	13
Grand Total	292
AKFTA	HS lines
CTH except from 72.19	2
CTH or RVC(40) (GR)	290
Grand Total	292
ACFTA	HS lines
CTH or RVC(40)	9
RVC(40)(GR)	283
Grand Total	292
AJCEP (Nov 07)	HS lines
RVC(40)	158
RVC(40) or CC	123
RVC(40) or CC with exceptions for certain tariff headings	3
RVC(40) or CTH (GR)	7
RVC(40) or CTH with exceptions for certain tariff headings	1
Grand Total	292
Source: Forthcoming paper by the first author for ERIA on ASEAN ROO. Source of basic data: ASEAN Secretariat, courtesy of MS. Anna Robeniol	

Table 5c. Food and Agri Products: Chapters 1-24

CEPT PSR for 2007 ROO		HS lines
RVC(40)		3
RVC(40) or CC		268
RVC(40) or CC or no CTC is required, provided that the good is produced by refining		32
RVC(40) or CTH (GR)		199
RVC(40) or CTSH		50
WO		129
no entries (i.e.#N/A)		48
Grand Total		729
AKFTA		HS lines
CC		2
CC + RVC(40)		2
CC or RVC(40)		30
CC, with exceptions for certain chapters, tariff headings		13
CTH + RVC(60)		1
CTH or RVC(40) (GR)		175
CTH, with exceptions for certain chapters, tariff headings		15
CTH, in conditions that the de minimis rule shall not be applied to a non-originating material		1
CTH, provided that materials from Chapters 7 & 9 are WO from any AKFTA Party; or RVC(40), provided that materials from Chapters 7 & 9 are WO from any AKFTA Party		1
RVC(35)		2
RVC(40)		17
RVC(40), with exceptions for certain tariff headings, subheadings		4
RVC(45)		4
RVC(60), provided that materials from Chapters 1, 2 & 5 are WO from AKFTA Party		2
RVC(70)		1
WO		427
WO from any AKFTA Party		26
WO from any AKFTA Party or RVC(45)		6
Grand Total		729
ACFTA		HS lines
CC		1
CC or RVC(40)		7
Manufactured from fats or oil wholly obtained in the ACFTA		1
RVC(40)(GR)		720
Grand Total		729
AJCEP (Nov 07)		HS lines
CTH and RVC(40) for Imitation sake and White sake;		1
CC		536
CC with exceptions for certain chapters, tariff headings		130
CTH		40
CTSH		8
RVC(40)		7
RVC(40) or CTH except heading 22.07		7
Grand Total		729

Source: Forthcoming paper by the first author for ERIA on ASEAN ROO.
Source of basic data: ASEAN Secretariat, courtesy of Ms. Anna Robeniol

4. RECURRING ROO ISSUES

The impact of ROO depends on:

- the margin between preferential tariff rates and MFN applied rates - as the MFN rates are reduced, the average margin of preference measured as the difference between the MFN rate and the concessional rate also decreases. A margin of preference of zero indicates that the MFN and preferential rates are the same and origin would play no part in the purchasing decisions of importers. A positive margin of preference indicates that MFN rate exceeds the preferential rate, and origin would play a part in those decisions. The higher the margin of preference, the more important determination of origin is for decisions about purchasing;
- the overall stringency of the origin criteria for conferring origin - the more stringent the rules the more difficult it will be for the parties involved to avail of the tariff concessions;
- the extent to which prescriptive ROO are used to limit the effects of preferential tariffs to members, e.g. supplementary accounting procedures to meet information and monitor compliance with original rules. While this may be relatively straightforward for large companies/exporters, this may discourage smaller exporters from seeking preferential entry.

With globalization and advances in ICT (information and communication technology) leading to growing international production sharing, amidst the increasing trend in preferential trading arrangements, these factors complicate even further the possible impact of ROO. Indeed, the administration of ROO has been beset with difficult recurring issues which are increasingly becoming an urgent concern.

- *Issue of Spaghetti (Noodle) Bowl Effect*

The technical nature of the ROO makes it *per se* difficult but the variations across FTAs (as discussed above) and the labyrinth rules make it even more problem-ridden. Precisely, it is the number and disparities of ROOs which give rise to the *spaghetti bowl effect*. Such overlap and inconsistency of the ROO systems must be addressed if one is to address trade facilitation issues.

- *Cost of Administration*

Even without the spaghetti-bowl effect, costs of implementing ROO could be substantial. Estimates vary: 3 percent of the value of goods traded for EFTA countries (Herin, 1986), between 4-4.5 percent (Manchin 2006) and 6-8 percent (Cadot et al., 2005) for other EU schemes. For NAFTA, Carrère and de Melo (2004) estimates the cost of ROO to be around 6 percent of the value of goods traded. Manchin and Pelkmans-Balaoing, using a gravity

model, finds that in ASEAN, for the preferential trade to positively influence trade flows, the margin of preference should be higher than 25 percent, suggesting an equivalent cost of ROO administration and compliance in ASEAN, much higher than estimates for EU and NAFTA.

Various ROO regimes would differ in their administrative requirements which would entail varying demands among exporters and importers alike. Compliance to the rules set may be difficult enough (whether VA, CTC or some other variation which would have different degree of restrictiveness). This is further expounded by the burdensome administrative process of verification and certification, and which may vary with the partner trading country. Usually, a certification serves as a verification of the origin of a given product. Hence, the type of certification adopted would have implication on the facilitation of trade. Some types (as in the case of EU's two-step system) require heavier involvement by the exporting country government and increase the burden of the exporters. On the other hand, there is the increasing adoption of a "self-certification" model (certified by a public or a private umbrella entity approved by the government) which entails lower administrative costs to exporters and government by transferring the burden of proof of origin to the importers themselves. (Estevadeordal and Suominen 2003) However, this method could be too untraditional for most ASEAN countries and its acceptability may pose a problem.

Another issue aside from cost is the potential arbitrariness in the process. Verification of origin is generally done at the national level in accordance with guidelines agreed upon in the ROO of the FTA. This mechanism creates several sources of rents, as the guidelines for valuing the final product and the domestic inputs are generally vague and can thus be manipulated and interpreted differently by national authorities, which have wide discretion in applying these rules (or even in the case of valuation of inputs), and can do so arbitrarily. (ADB 2002)

In any case, the differences in the rules and how they are administered, not just across but within countries would entail confusion and more likely result in the limitation of potential market depending on its consistency with one's domestic policies. It is thus logical for countries engaging in numerous FTAs to adopt uniform rules of origin. Indeed, it makes coordination in ROO regimes in the region imperative.

- *ROO as a protectionist tool: differential impact of restrictive/lax rules*

ROO can either facilitate or restrict trade depending on the adoption of permissive or restrictive rules. In designing the ROO, a country can increase or decrease the degree of restrictiveness of ROOs using certain provisions—e. g. the preparation of a separate listing of operations that are in all circumstances considered insufficient to confer origin such as simple operations of cleaning, packaging and labeling; the prohibition of duty drawback which preclude the refunding of tariffs on non-originating inputs that are subsequently included in the final product exported to a FTA partner market; and the imposition of high

administrative costs. (Estevadeordal and Suominen 2003) In this regard, ROOs could be used as a protectionist trade instrument. Since ROOs are negotiated industry by industry, there is enormous scope for well-organized industries to essentially insulate themselves from the effects of the FTA by devising suitable ROO. Political variables that arbitrate the level of tariff and trade protection could come into the picture and affect the restrictiveness of ROOs. This has been suggested to be the case for developed countries, e. g. the EU and the United States. A report by Australian Productivity Commission found ROO laws under the two Australian FTAs (the United States and Thailand) are possibly among the most restrictive in world trade.⁵ Furthermore, agricultural products and textiles and apparels appear to have relatively more restrictive ROOs. (Estevadeordal and Suominen 2003)

The logical conclusion is for the possible EAFTA to avoid using ROO as a protectionist tool. This means limiting product specific rules to those which are clearly for facilitating and simplifying administration. This could, however, be subject to difficult political constraints in some cases.

- *Issue of trade and investment diversion*

For some firms, the margin of preference will be sufficient to induce them to accept a less favorable input mix and a higher cost structure in order to obtain preferential access for their exports of finished goods to other countries in the FTA. Other firms may forego preferential treatment for their final products in the FTA market by continuing to obtain inputs from the preferred suppliers outside the FTA area. They may judge that the compliance costs and efficiency losses involved in changing input sources. In either case, trade diversion could result creating inefficient allocation of resources.

With respect to investments, ROO can induce changes in the location of production between member countries of an FTA. Some production may be relocated from outside the FTA in response to a desire to meet origin requirements and make that production eligible for duty free access to the FTA markets.

Where ROO effectively allow minimal or no third country inputs (as in the case of sensitive sectors such as automotives, textiles, and clothing), producers in member countries may have little choice but to establish domestically-focused (import competing) operations with majority of the inputs obtained locally.

ROOs could be an important determinant of specialization patterns in preferential trade agreements. Restrictive ROOs could create an incentive to increase the amount of intermediate and final good manufacturing, processing and assembly done within the preferential area at the expense of the facilities in the other country which would otherwise have a comparative advantage. Firms base their decisions on production and location on country's trade protection creating an incentive for trade diversion in favor of a particular

⁵ www.news.com.au December 12, 2004.

FTA to avail of the preferential treatment. (ADB 2002) Furthermore, this may encourage intra-FTA producers to shift to suppliers in the cumulation area. (Estevadeordal and Suominen 2003) This distortion causes an inefficient allocation of global resources. (La Nasa 1995).

It has been documented that depending on how the ROO is formulated, FTAs can perpetuate inefficiencies. Some firms may find that their efforts to lower costs and increase productivity through technical innovation and improved business practice can prove to be an advantage to them in meeting the requirements of the ROO. For example, a firm may find that through increased productivity it can no longer meet the national/regional value content threshold. It could also be penalized if it purchased inputs more cheaply from preferred sources worldwide. It would seem that to continue to benefit from preferential tariff agreement, firms would be required to retain less efficient productions patterns.

The bottom line is that a liberal ROO regime would reduce, if not remove, the possible negative trade and investment diversion impact of free trade arrangements.

- *Treatment of Duty Drawback*

Related to the issue of trade and investment diversion is the treatment of the duty drawback. Most preferential agreements prohibit duty drawbacks granted to non-originating materials used in the production of a final product for export to partner country. This policy discourages the use of third country inputs in the production processes and thus contributes to allocation inefficiencies. In addition, it could be very important for countries with heavy production links with third party manufacturing networks. Clearly, the policy on duty drawback reflects ROO restrictiveness and protectionist tendencies of receiving countries. The most affected would be an exporting developing country partner.

These are just some of the major issues which the “new age” cooperation initiatives would need to deal with. Detailed issues about its administration can be even more important to actual trader and importer. Nonetheless, it is crucial that these general concerns be addressed in a rational framework when setting the ROO regime for EAFTA.

5. CONCLUSION AND RECOMMENDATIONS

The various plurilateral and bilateral FTAs in East Asia have given rise to the web of complex rules of origin. Though intended to facilitate trade, promote investment and protect sensitive local industries from “unfair competition”, in reality preferential ROO provisions in the current FTAs are overly complex and could impose unintended consequences for business.

Clearly the divergence of the ROO provisions across FTAs, their restrictiveness, complexity of the rules and requirements for compliance have remitted in more administrative costs for the public and private sector. These costs have reduced the value of the tariff preferences made available through the preferential agreements.

Estimates of ROO costs vary. Herin (1986) estimated the cost to be around 3 percent of the value of goods traded for EFTA countries. Manchin (2006) estimated a range between 4-4.5 percent and Cadot et al (2005) between 6-8 percent for other EU schemes. For NAFTA, Carrère and de Melo (2004) estimated the cost of ROO to be around 6 percent of the value of goods traded. Manchin and Pelkmans-Balaoing, using a gravity model, finds that in ASEAN, for the preferential trade to positively influence trade flows, the margin of preference should be higher than 25 percent, suggesting an equivalent cost of ROO administration and compliance in ASEAN, much higher than estimates for EU and NAFTA.

JETRO surveys in ASEAN countries note the considerable amount of time and paperwork involved in obtaining Form D (the official form to prove origin in AFTA). Compliance with ROO involves numerous documentation requirements (including invoices and other evidence for each input used in the final product). These problems are magnified for small firms. In addition, ASEAN requires that Form D should be issued by designated government departments, unlike many other FTAs where private sector associations are allowed to issue certificates of origin. The 2006 JETRO Survey of Japanese Firm's International Operations shows that around 30 percent of 97 Japanese MNCs surveyed using or planning to use FTA preferences in East Asia view the existence of different rules of origin as complicating their trade businesses and leading to increased costs—either through having to deal with complicated procedures to prove country of origin or even having to change some productions processes. Another 33 percent expected to see increased costs in the future. Furthermore, 64 percent of firms thought that rules of origin should be harmonized, with the largest number (24.7 percent) preferring to be able to choose either the value added (VA) rule or the change in tariff classification (CTC) as the common rule. Thus, it seems that multiple ROOs are beginning to manifest themselves as a problem in East Asia. (Kawai and Wignaraja, 2007)

Nonetheless, JETRO (2004) Report on ASEAN's FTAs and Rules of Origin finds some improvement in the share of CEPT exports. The share of CEPT exports to total ASEAN exports more than doubled from 10.8 percent in 2002 to 22.5 percent in 2003. This likely indicates CEPT preference is more utilized and that reforms undertaken have had a positive impact.

Therefore, to achieve significant benefits in terms of reduction of the cost of doing business across the region and seamless trade and production it would be necessary to rationalize the differing rules of origin in the various FTA's in the region. Consolidation of multiple membership agreements around more liberal rules of origin will serve a tool for diminishing spaghetti bowl related cost of trading under preferential regime. It will also

minimize the potential trade and investment diversion costs, as pointed out in the previous section.

RECOMMENDATIONS:

The ROO regime for EAFTA should be premised on the principle that it should lead to the reduction of the cost of doing business across the region and promote seamless trade and production. Towards this end, the ROO regime for EAFTA should entail the following key features:

- *Simplicity and Efficacy*

There is a consensus that the movement should be towards more simple and unrestrictive ROO. Simpler ROO will help promote regional trade and international competitiveness of member states. Simple rules will reduce compliance costs and administration itself of trade and customs procedures. To minimize the potential for unproductive rent-seeking and corruption, a simple and transparent ROO is important. (ADB 2002)

In general and in theory, this means using a single, least restrictive rule. But in practice using co-equal rules would be more practical. The flexibility it provides would have a liberalizing as well as cost-reduction impact for exporters.

In this regard, the use of CTC as an alternative (either/or) method to the VA rule would help. The CTC method is easy for Customs authorities to implement. At the same time, SMEs might also find it easier to comply with, simply needing to show import and export invoices with different classification code. The question is determining the level of disaggregation the member countries would deem to satisfy “substantial” transformation, which would vary across commodities. Here, protectionist tendencies would surface and agreements (especially between developed and developing countries) might be difficult. Nonetheless, the general rule should lean towards less restrictiveness. This implies using a common rule across products, possibly at a 4 to 6-digit level, and if any, with very limited product-specific exemptions.

The reforms in ASEAN ROOs appear to be heading toward this direction. It has started to introduce CTC as a substitute criterion. Early on, the product coverage is limited to: iron & steel products in HS Chapter 72, textiles and textiles products, wheat flour, aluminum and wood-based products. An increasing number of products are now being covered to apply CTC as alternative criteria to the VA rule for products in additional nine priority sectors, namely: (i) agro-based products; (ii) automotives; (iii) electronics; (iv) fisheries; (v) rubber-based products; (vi) textiles and apparels; and (vi) wood-based products.

Japan’s latest bilateral agreements with ASEAN countries has similar elements-predominantly CTC, with alternative use of VA for most. The problem would be the

different levels of disaggregation used and it is doubtful how liberalizing the regime could be. In any case, it appears that Japan's plan is to more easily consolidate the ROO into a Japan-ASEAN ROO.

Another suggestion being considered in various FTAs is the use of self-certification. It is not without its own problem, as previously mentioned, but this would simplify and lighten the administrative burden considerably.

Finally, *de minimis* rules (which allow for a specified maximum percentage of non-originating materials to be used without affecting origin) can greatly simplify ROO. It could be set well within a level for the intent and purposes of "substantial transformation" but a higher cut-off would represent a more liberal approach to ROO.

While the use of *de minimis principle* appears to become a common feature in newer partnership agreements, upon closer examination, application is usually on a product specific (PSR) basis. A wider application of *de minimis* rule using generous ceiling would be a major step to simplifying ROO and lowering the cost of compliance.

- *Flexibility*

Internationalization of production and accompanying technological changes would require periodic revision of the ROO, especially in product groups where technologies and production processes change fast. ROO should be flexible enough to accommodate these changes. Nonetheless, product specific rules should be avoided. Otherwise, there would be a tendency of "privatization" of trade policy brought about by the need for periodic revision. There should at least be some well-defined procedures or guiding principles for introduction of amendments in the harmonized ROO. Again, in practice, an either/or approach might be useful.

- *Cumulation Rule*

ROO provision for cumulation (referred to as well as accumulation) would be a crucial feature to include in a regional trading agreement. Full cumulation is an important factor allowing for the development of regional production networks. This provides for deeper integration and allows for more advanced countries to outsource labor-intensive production stages to low-wage partners. Coupled with simple ROO, this full cumulation will make it easier for regionally-based firms to exploit the economies of scale. (Brenton 2003) In addition, cumulation provisions would address problems of protectionist tendency in the ROO and investment (and trade) diversion effects, at least within the wider grouping of member countries.

An issue is how to deal with non-member countries. To what extent should cumulation be allowed so as not to frustrate the preferential status of the FTA partners? Should this follow the traditional Pan-European system or the more aggressive US-Singapore ISI? What

combination of policies or rules is acceptable? The easy answer is to include a guiding principle, for example, a development dimension in these rules involving simple interpretation.

Aside from cumulation, roll-up or absorption principle, which allows materials that have acquired origin by meeting specific processing requirements to be considered an originating good when used as input in a subsequent transformation, could also be recommended for a more liberal ROO approach.

For its part, ASEAN is developing a “partial” cumulation approach. The practice in ASEAN is to count “components as part of ASEAN content which themselves have ASEAN content of 40 percent or more.” Upon recommendation during the September 2004 AFTA Council Meeting, the percentage content requirement was reduced to 20 percent of ASEAN content.

This move is envisioned to help most developing ASEAN member countries, whose sources of inputs, given the GPN (global production network) structure, would come from outside the region. Some estimates show that in most ASEAN countries, for major manufactured exports (e. g. textile, garments and electronics) total ASEAN content is less than 20 percent . (Manchin and Pelkmanns-Balaoing, 2007)

- *Harmonization of Customs Procedure*

Customs clearance is still a problem in most of the less developed countries of East Asia. A complex ROOs accompanying a free trade agreement can further complicate rather than facilitate trade in the region. Along with harmonization of ROO standards, there is even greater need for the streamlining of customs procedures and simplification of customs clearances including the introduction of paperless trading in many FTAs. The objective is to minimize documentation costs. Harmonization of customs procedures in general would be a big step in this direction. Related to this is the harmonization of commodity classification regionwide. ASEAN has developed a Harmonized System at a 6-digit level. Work should be done to come up with a harmonized system for all of East Asia.

This is consistent with the principles of predictability, transparency and consistency required in the ROO. Another practical option is for the countries to work towards becoming a signatory to the Kyoto Convention. This however could be costly for developing countries, most of which are unable to comply with the requirements.

- *Developing country Dimension*

Establishing a regional regime of ROO for East Asia must ensure that it does not pose difficult disadvantages to the less developed developing countries. There is a need to add this dimension to the ROO regime.

Developing countries need to be able to latch on to the GPN. This means gearing the ROO regime towards the preparation, development, and internationalization of SMEs. The ideal ROO therefore should have a developing country dimension. What would this entail? Needless to say, capacity building is crucial, for exporters, importers and administrators in developing countries, if the region is to achieve the best practice in the rules of origin. Developments in the EC for development-friendly ROO includes a single value-added method, use of statement of origin by registered exporters, and training and technical assistance to improve evaluation, information flows and monitoring of compliance. A key element is allowing alternative means of proving origin more suited to the development stage of the developing country member.

A logical concession to developing member countries is to lower the VA criteria for its exporters. Findings for the EU shows that a decline in the value-added threshold would tend to increase utilization rates. This could be a most useful incentive for CMLV countries.⁶

The discussion above suggests the following elements that should be considered in crafting the ROO regime for EAFTA.

General Guidelines

1. Consolidation of the multiple membership agreements in the region around more liberal ROO should be the general guideline to achieve the vision of an East Asian community. This is not just a theoretical underpinning. It is something that is feasible based on the following findings:
 - The AFTA ROO is considered relatively simple and liberal. The generality in application is a plus factor. In addition, reforms being sought lean towards more liberal rules by attempts toward “expanding/easing standards.” (Needless to say, a lot more can be done to improve the system.)
 - The point is that the AFTA ROO is a practical starting point. The existing FTAs in East Asia are more or less consistent with AFTA ROO, specifically with the use of 40 percent RVA.
 - In general, there is a trend towards progressively more liberal ROO regime in East Asia.

⁶ The value-added requirement should be based on whether the potential gains in terms of greater regional trade significantly outweigh the risks of trade deflection. Kirk (2007) suggests 30% value-added requirement would be sufficient to prevent significant trade deflection.

- As such, especially with continuous effort to clarify and improve issues of implementation, the AFTA ROO would provide a good starting point for EAFTA towards clarifying and improving the ROO system.
 - Necessarily, there should be a coordinated and cooperative action among member countries.
2. Rules toward adopting full cumulation, and roll-up (absorption) process should be adopted and further developed.
 3. The *de minimis* provision should be applied more extensively. This could yield significant impetus for deeper regional integration.
 4. Another key measure that should be explored is self-certification. This could contribute substantially to simplification and cost reduction. This should be balanced by some monitoring system that would keep importers honest.
 5. Applying restrictive ROOs targeted at sensitive products is not an effective mechanism for protecting domestic industry and should be limited.
 6. Special and Differential Treatment: ROO be devised by taking into account the different levels of development of countries in the East Asia region, e. g. using lower Value Added content
 7. Another challenge is to craft a system of ROO that would be SME friendly. One aspect of this is capability building to enable SMEs to comply with ROO requirement. Modules and templates for value-added accounting, could probably be developed over time for SMEs to use.
 8. There is a need for greater harmonization of customs procedures for the benefits from ROO reforms to be maximized. In particular, the region should work towards a Harmonized System of Customs Classification.
 9. Finally, the formulation of the ROOs should have both simplification and liberalization elements. At the same time, however, there should be adequate provisions that would control for potential abuse.

Some Suggested Specific Measures

- Towards ROO consolidation
 - A first step to consolidation of ROOs is to harmonize on a product basis. In examining the ROOs across commodities for AFTA and the ASEAN + 1 FTAs, a lot of commonalities are noted. Consolidation could start with these commonalities. A further step is to harmonize a next round of products with

- some but minimal differences, and where possible, merge by applying the MRA (mutual recognition) principle.
 - Another possible step is to multilateralize AFTA as a minimum ROO criterion (leaving more liberal rules to be applicable).
 - The final step is to consolidate and gravitate around the FTA with the most liberal rule.
- Efforts should be extended to assist the exporters in calculating inputs arising from different FTA and non-FTA sources, especially for SMEs.
- For the RVC rule, it is important to come up with a standardized method of calculating value by creating more specific set of principles for calculating both local and foreign inputs. Guidelines for costing methodologies should factor in price and exchange rate fluctuations as they can change the input costs over time. (USAID/Nathan Associates, 2006)
- Procedures for self certification should be considered. Self certification can take two forms. The first is a hybrid approach which would allow self certification by accrediting industry associations or individuals to certify if the good is qualified for preferential treatment. The second is full self certification, where the exporter can certify origin in his individual capacity and responsibility.
- These are radical moves, especially for ASEAN. Nonetheless, it is not completely unrealistic to offer exporters different options. There are ways to minimize abuse. This is especially true for the hybrid approach, which is currently used by the EU (with partnership with EFTA, Mexico, Chile) and EFTA partnerships with the same countries. The government (or its designated agency) authorizes exporters (industry associations, for example). The government agency would establish procedures for accreditation, where exporters/associations could apply. The main responsibility of the certifying body is to be able to address verification issues.
- Safeguards against abuse could be embedded in clear ROO provisions on verification.
- The verification process should be improved to lessen its potential as an impediment while at the same time provide the necessary safeguards. One way to do this is to minimize direct interaction between Customs officers and exporters in post-audit checks. ASEAN should work on creating a system of automated verification process that would lessen dealings between the Customs and exporters,
- In this regard, it is important to set up a database system that would have necessary and relevant information and documentation (which could be made secure) to facilitate the verification process. It would also be helpful if the private sector is

involved in the post-audit check instead of leaving the task solely in the hands of one agency, in this case, the Customs office.

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