

## Summary

### Preferential Trade Agreements: are Rules of Origin a Protective Device?<sup>1</sup>

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The establishment of special trading relationships involving a certain degree of preference for specific partners usually implies proving the origin of the products included in those concessions by meeting certain conditions. These conditions constitute the rules of origin (RoO) – a set of rules that permits determining whether a product is originating or non-originating in the area.

Thus, when preferential trade agreements are established, the RoO define the conditions under which an importing country may consider a product as originating from an exporting member of

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the economic bloc and so is entitled to a special and discriminatory treatment in relation to other countries.

The disseminated use of discretionary RoO is justified by the growing formation of free trade (FTA) and preferential trade areas (PTA), in which member countries apply their own trade policies to third countries, including differentiated import tariff rates. In order to confer the special treatment only to the associated countries, it is necessary to prevent the transshipment of goods produced outside the bloc, through the exportation to the member partner that maintains the lowest tariffs.

In the case of a customs union, in which member countries share a common external tariff (CET), this transshipment of goods is ineffective, unless it takes place in a transition period in which different rates for specific products still prevail. This is the case of the Mercado Común del Sur (Mercosur), which, ten years after the implementation of the Treaty of Ouro Preto, remains as an imperfect customs union.

By assigning origin to products that benefit from concessions granted among PTAs, the RoO pave the way back from the process of globalization of productive processes. Nevertheless, the potential burden of their utilization should not be minimized.

First, RoO induce the firms in a PTA to use a greater and often more expensive amount of regional inputs, so that they can sell duty-free in the preferential market. This option diminishes the potential liberalizing effects of free trade: the high costs of intermediate goods affect the production of final goods, reducing their demand and afterwards the demand for local inputs.

Therefore, it is a mechanism that induces trade diversion. It is common knowledge that the magnitude of the diversion is directly proportional to the difference between the most-favored-nation tariffs and the preferential tariffs. Thus, it is extremely important for such a difference to be as small as possible, which is easier to occur when the MFN tariffs are low.

The increase in the production costs is worsened by the burden of the administrative costs related to the certification of origin of the goods, which are imposed on the exporters and, in many times, on importers and on government agencies.

Secondly, an extremely negative aspect consists on the possibility of using RoO as a “hidden protection” mechanism, replacing other trade and non-trade barriers, such as tariffs and quotas, which are increasingly criticized in multilateral forums. As observed, the incidence of more stringent criteria for determining origin is more easily detected in sensitive sectors of developed countries, which often display the highest tariffs, such as agricultural products, processed food, textiles, clothing, and footwear. The results obtained reveal that preferential tariffs, granted unilaterally or in trade agreements, may be totally or partially neutralized by a growing number of requirements, which may combine various criteria to characterize a “substantial transformation” of a commodity.

This paper has two main objectives. The first one is to evaluate the possible restrictive effects of RoO regimes, through the comparison of three different trade agreements – namely, the Nafta, the European General System of Preference (EU-GSP) and Mercosur. As a second goal, it will be assessed the direct relationship between the role played by the RoO and that of the import tariff rate structure. As it will be investigated later on, more restrictive RoO may be reinforcing and even replacing tariff protection.

Recent studies evaluate the RoO regimes using a taxonomy based on the requirements contained in the protocols adopted by countries and economic blocs, such as the Nafta and the EU.

However, such a classification does not always reflect the level of requirement actually established for a product to be considered originating. Some examples illustrate certain shortcomings, which may lead to misinterpretations. In the Nafta, the requirement for a live animal to be considered originating is the change of chapter in the productive process. Since it is impossible to accomplish this requisite, the rule actually demands that the animal be wholly produced, i.e., born and raised in the territory of the preferential trade area. With regard to orange juice, the text also requires a change of chapter, but excludes the position, in which fresh oranges are classified. Thus, orange juice will be conferred origin only if it is wholly produced, which precludes its manufacture from the non-originating input (fresh oranges).

In order to prevent this kind of problem, the usual requirements included in the analysis of the trade agreement texts were revised product by product. The reinterpretation of those requirements implied the RoO classification adopted in this paper.

When different rules were specified for the same product, allowing the exporter to make an option, the least restrictive one has always been chosen.

The results obtained for both EU-GSP and Nafta present a very similar pattern:

- a) there is a positive correlation between the degree of restrictiveness of the RoO and the tariff rate levels; for Nafta, the concentration of textile and apparel products with tariffs exceeding 10% and with the most restrictive levels of RoO suggest the proportions of the protection afforded to those industries. In the EU-GSP scheme this position is fulfilled mostly by the agricultural sector;
- b) the less stringent RoO include products such as machinery, equipment, tools and appliances, chemicals, among other manufactured products;
- c) the highest degrees of restrictiveness can be identified in textiles and clothing as well as agricultural and animal products and their derivatives, in the EU-GSP, whereas in the Nafta, most of the products consist of textile and clothing products; and
- d) in both regimes, the goods enjoying the maximum degree of restrictiveness in terms of RoO are the agricultural and animal products.

The results obtained for Mercosur are not strictly comparable to the previous ones, simply because the RoO are not so relevant. The lowest degree of restrictiveness of RoO are mostly related to chemicals, steel and other metal products, while the highest degree includes textile and clothing and agricultural products.

The configuration presented by Mercosur differs from that of the other blocs due to the fact that only a relatively small group of products does not share a common external tariff (mostly capital goods and information technology and telecommunications products). The need of real functional RoO does not in fact apply to the rest of the goods traded by the member-countries.

In sum, for Mercosur, no positive correlation apparently exists between tariff levels and the degree of restrictiveness of RoO.

Considering that the negotiations of RoO in preferential trade agreements are carried out on an “industry-by-industry” or “sector-by-sector” basis, the chances of “rent-seeking” are much more favorable for the most powerful and influential productive sectors. The analysis performed in this paper confirms that those organized private groups seldom miss these opportunities.

Given the inexorability of free trade areas and similar associations, a basic suggestion to reduce the observed distortions would be the adoption of limits on the content of RoO and ultimately the establishment of a future single rule for all products, like a certain percentage of value added.

An additional measure in favor of a more effective trade liberalization between preferential partners that preserve their own external tariffs would be, as pointed out, to reduce the tariffs applied to the trade with third countries.

Finally, even though Mercosur is still an incomplete customs union, it has been proved that the adoption of a CET helps to discourage the use of RoO in order to increase the protection level of certain productive activities or sectors.