
Enhancing Trade Preferences for LDCs: Reducing the Restrictiveness of Rules of Origin

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The 2001 Doha ministerial declaration reaffirmed WTO's commitment to the least developed countries (LDCs) through trade preferences and trade-related technical assistance. The declaration lays down the objective of "duty-free, quota-free market access for products originating from LDCs" and pledges to "consider additional measures for progressive improvements in market access for LDCs" (paragraph 42). How the terms in the first objective are defined and enforced is crucial in determining how much market access preferences actually provide. The European Union's Everything But Arms agreement (EBA) provides an example. EBA offers duty- and quota-free access to LDCs.¹ But the rules that it imposes² to define whether a product in fact originates in an LDC and is therefore eligible for preferences are very restrictive. Other preference schemes have similarly restrictive rules of origin. A move to less restrictive rules would bring significant improvements in market access for LDCs.

Here we concentrate on the rules of origin for EU preferences, which are currently being reviewed. The review offers an opportunity for the European Union to enhance the preferences that it offers to developing countries, especially the least developed. However, there is plenty that other developed countries can do to improve their trade preference schemes. For example, the U.S. generalized system of preferences (GSP) excludes a wide range of products of relevance to LDCs. The African Growth and Opportunity Act (AGOA) includes some of these products, such as clothing, while excluding others—among them textiles and certain agricultural products—as well as all products from LDCs not covered by AGOA. Thus there is still much that the United States could do to achieve the objective set forth in the 2001 Doha ministerial declaration, starting with a review of the rules of origin applied in the GSP and AGOA.

The nature of the rules of origin

Rules of origin ensure that only products from beneficiary countries are granted trade preferences by preventing trade deflection, whereby products from nonbeneficiary countries are transshipped through the beneficiary (with minimal processing) so as to avoid the payment of tariffs. Avoiding trade deflection is in the interest of the country that grants the preference as well as the one that receives it. However, rules of origin for trade preferences are set by the preference-granting country, and are often manipulated to achieve other objectives, such as protecting domestic producers. When domestic interests are allowed to influence the scope

and terms of rules of origin, the outcome tends to be far more restrictive than is necessary to prevent trade deflection. Too often, the result is that market access for the beneficiaries is limited, and the objective of promoting developing-country exports is undermined. In practice, products that are important for many developing countries—such as textiles, clothing, and processed agricultural products—are often excluded from preference schemes (pointing to the need for duty-free access for *all* products). When preferences are made available for sensitive products, they are usually accompanied by particularly restrictive rules of origin.

When a product is produced in a single stage or is wholly obtained in the beneficiary country then its origin is relatively easy to establish. In all other cases rules of origin must specify the methods to be used in ascertaining that the product has undergone *sufficient working* or processing or been subject to a *substantial transformation* in the beneficiary country. Such tests are designed to determine that products have not been transshipped from a nonqualifying country or been subject to only minimal processing. The higher the level of working that is required by the rules of origin, the more difficult they are to satisfy and the more they constrain market access (relative to what would be required simply to prevent trade deflection).

For many products, and for almost all sensitive products, the current EU rules of origin link the implied definition of “substantial transformation” to the sourcing of raw materials.³ Thus, a clothing producer in Africa who imports fabrics from Asia may not receive preferences. A cannery may not use fish originating from outside the preferred jurisdiction. A producer of bakery products may not use imported flour. In effect, the rules of origin deny producers in developing countries freedom to choose the source of their inputs, which often means that production capacities that could have had a substantial economic and development impact are denied preferential access to the European Union. In some cases it may mean that investment in such capacities may not take place.

If needed inputs are competitively produced by local firms, exporters will always source locally to avoid transport and other trade-related costs. However, if the right inputs are not available locally at a competitive price, then producers must look to overseas suppliers. When rules of origin prohibit the use of imported inputs they may force exporters to use materials of higher cost, thus undermining their ability to compete in global markets. The aim of trade preferences, of course, is to stimulate exports and export diversification in beneficiary countries and so to provide a boost toward achieving global competitiveness and sustainable economic activity. That objective can be completely undermined by rules of origin that dictate the use of high-cost inputs.

The opportunity for reform in the European Union

The reform of rules of origin currently being considered by the European Union is a critical opportunity to support exporters in the LDCs. EU trade preferences would be considerably enhanced if producers in small developing countries were allowed to choose freely the source of the inputs they require, a freedom denied by the current rules. The opportunity to give meaning to existing preferences will be lost, however, if protectionist interests succeed in maintaining or even increasing the restrictiveness of the rules of origin

The current EU rules of origin are product-specific, sometimes complex, and often restrictive. Their restrictiveness is reflected (a) in low utilization rates of preferences and (b) the significant expansion of exports under other preference schemes that have more liberal rules. They are particularly restrictive with respect to products of comparative advantage for Africa and low-income countries, namely, processed agricultural products and clothing.

Restrictive rules of origin lead to underutilization of preferences

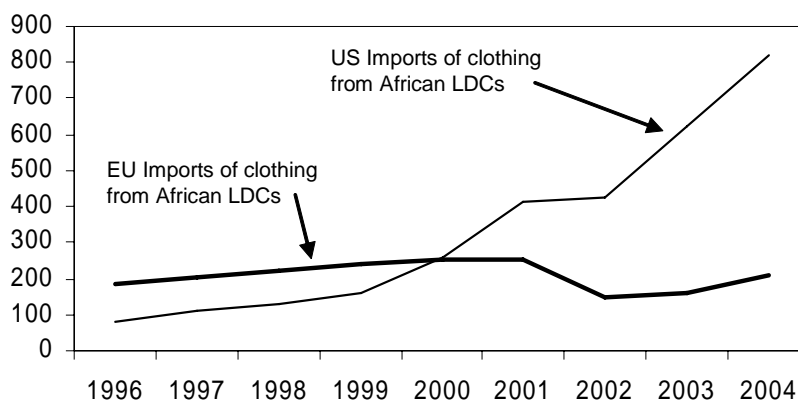
For those LDCs that are eligible for the EBA but for no other EU preference scheme,⁴ less than 50 percent of the available EBA preferences are utilized. The principal export of Bangladesh to the European Union is clothing, yet exporters request preferences for only half of their clothing exports. Why? Because to be competitive they must use the cheapest and most appropriate fabrics. The best source of such fabrics may be China, but EU rules of origin disqualify from preferences clothing made from Chinese fabrics.

Utilization rates for certain ACP countries, which may choose between GSP/EBA and the Cotonou Agreement, can be higher. However, these data can be misleading. The EU's restrictive rules of origin for key products such as clothing can be prohibitive for small, low-income countries, keeping them out of the market altogether. Utilization rates show the share of *actual exports* that are eligible for preferences but do not request them. They do not capture the potential export capacities stifled by restrictive rules of origin. The differential supply responses in Africa to U.S. and EU preferences for clothing illustrate this principle. Liberal rules of origin have strongly stimulated U.S. imports of clothing from African LDCs, while EU imports have stagnated because of strict rules of origin (figure 1).

Restrictive rules of origin constrain export diversification

Clothing can be a key sector for export diversification, and thus for development. By manufacturing clothing, developing countries can exploit their comparative advantage in low-labor-cost operations. Advanced technology is not required, start-up costs are comparatively small, and scale economies are not important— all of which favor production in locations with low labor costs. Current EU rules for clothing, however, prohibit the use of imported fabric. To obtain preferences, clothing

Figure 1. With liberal rules of origin, US clothing imports surge
US \$ million



Source: USITC Dataweb and EUROSTAT.

producers must use local or EU fabrics (or fabrics from countries with which cumulation is permitted). They may not use fabrics from the main fabric-producing countries in Asia and still qualify for EU preferences—a binding restriction, since few countries in Africa have competitive fabric industries.

Since 2000, with the passage of AGOA, the United States has offered preferences on imports of clothing from African countries under much more liberal rules of origin: making up fabric into clothing is sufficient to confer origin. The U.S. rule allows African clothing manufacturers flexibility in sourcing fabrics.⁵ In the face of restrictive rules of origin, EU imports of clothing from African LDCs are lower in 2004 than they were in 1996, while U.S. imports have flourished, increasing 10 fold since 1996 and are now almost four times greater than the value of EU imports of clothing from African LDCs (see figure 1).

The rapid increase in exports from African LDCs to the United States has had a negligible impact on the U.S. market, where African LDCs still account for little more than 1 percent of total U.S. imports of clothing and a much smaller proportion of total U.S. consumption of clothing products. Even so, the United States does not offer comparable access to all LDCs; those in Asia are still excluded. Further, the third-country fabric rule of AGOA is due to be removed in 2007, before many countries in Africa have had the opportunity to benefit and with detrimental impact on those that have been able to do so. The general rule of origin for the U.S. GSP and AGOA is a value-added requirement of 35 percent, which is likely to be very difficult for many small developing countries to meet in the absence of rules comparable to the AGOA third-country fabric rule, because the higher the

value-added requirement, the more difficult it is for low labor cost countries to satisfy the rule relative to countries with higher labor costs.

If the full market-opening opportunities of EBA and the EU's GSP are to be realized, a significant relaxation of EU rules of origin will be required. Recognizing that rules of origin have constrained the developmental impact of the GSP, the European Commission has proposed a value-added rule to define origin for all products. A preferable alternative, would be to give developing countries, especially LDCs, the flexibility of satisfying *either* a value-added rule *or* a change-of-tariff-heading requirement. At what level should the value-added requirement be set and what degree of cumulation should be allowed? The Blair Commission proposed a value-added requirement on all products of no more than 10 percent, which would allow African exporters the flexibility to source inputs and to exploit their comparative advantage in labor-intensive products.

The issue of cumulation

Cumulation is an instrument that allows producers to import materials from a specific country or regional group of countries without undermining the origin of their product. In so doing, it offsets the restrictiveness of a particular set of rules of origin. However, as long as the most efficient producer of the required inputs is excluded from the area of cumulation then the offset will be partial and may well be worthless. We have no strong empirical evidence of the importance of cumulation provisions, but the information we do have does not suggest a strong impact.⁶

If the value-added requirement is low enough, there is no need for cumulation. If it is high, then the rules must allow for *global* cumulation if LDCs are to be able to exploit their comparative advantage. With global cumulation, inputs from any developing country, including China, would count as qualifying content. Current EU proposals for limited regional cumulation are likely to do little to mitigate the restrictiveness of high value-added requirements. Global cumulation, by contrast, would allow sourcing of inputs from regional partners and help promote regional integration; by not limiting cumulation to the region, it also would avoid excluding the lowest-cost source of inputs.

However, a low value-added requirement (10 percent) common across all products would be more transparent, simpler for firms to satisfy, and easier to administer by customs and other agencies. Setting a high value-added requirement (such as 40–50 percent) and allowing limited regional cumulation is most unlikely to provide for a substantial easing of the rules of origin. It could even make them *more* restrictive.

Fears that a low value-added requirement or global cumulation would benefit mainly China are overstated. In fact, the benefits to China probably would be very small. Many producers in developing countries already choose to use Chinese inputs, because the cost penalty of not using the least expensive inputs is often

greater than the tariff preference. Restrictive rules of origin and limited cumulation will not induce these producers to use other sources of inputs. By contrast, a low value-added requirement (or global cumulation) will allow developing-country producers that have chosen for competitive reasons to use Chinese inputs to receive preferences and, in principle, realize higher returns for their exports. If competitive inputs are available locally they will always be used. Global cumulation will benefit China only in cases where producers previously sourced inputs domestically or from a country in an area of cumulation solely for the purpose of receiving preferences.

Conclusions

Reform of the rules of origin governing preferences offers the European Union a crucial opportunity to improve market access for LDCs and other developing countries and to enhance the value of their trade preferences.

Current EU rules of origin severely limit the ability of producers in small developing countries to source inputs on a global basis and still receive preferences. Trade preferences should be designed to help countries reach global competitiveness in industries in which they have a comparative advantage. In the globalized economy such competitiveness must be based on the freedom to source inputs from the most suitable and least expensive location. The global market exacts a high penalty on producers that use inappropriate or high-cost inputs.

The U.S. experience with AGOA shows that a bold approach to rules of origin can provoke substantial supply responses from developing countries and help them build a more diversified export base.

By reforming the rules of origin for LDCs to provide a value-added requirement of no more than 10 percent across all products in the EBA (with the alternative of satisfying either the value-added rule or a change-of-tariff-heading requirement), the European Union would widen access to its market in a manner consistent with the Doha process and with the ongoing adjustment to the expiration of quotas on textile and clothing products. If a beneficiary country feels that this is not commensurate with its development objectives they should be allowed to petition for a permanent derogation of more restrictive rules on their exports to the European Union.

Similar arguments apply to Japan and the United States, which could enhance the preferences they offer by broadening product and country coverage to provide duty- and quota-free access for all products produced by all LDCs, and also by reviewing the effectiveness of their rules of origin in stimulating the exports of LDCs.

Notes

1. The vast majority of products exported by LDCs to the European Union were already eligible for duty- and quota-free access under existing provisions of the GSP.
2. There are no multilateral rules or disciplines on preferential rules of origin. An attempt was made in the Uruguay Round to harmonize *nonpreferential* rules of origin, which define origin for purposes of basic trade-policy measures such as the application of tariffs, the marking of goods, and the collection of statistics, and for use in contingent protection (such as antidumping, countervailing, and safeguard measures). Some progress has been made on these rules, but the negotiations have bogged down, and several deadlines for the completion of the work program have been missed.
3. Block and Grynberg (2005) draw this out very clearly for processed fish.
4. Afghanistan, Bangladesh, Bhutan, Cambodia, Laos, Maldives, Nepal, Yemen.
5. Initially, South Africa and Mauritius were excluded from the more liberal rule of origin. They faced a far more restrictive NAFTA-type rule requiring production from fiber. Mattoo and others (2004) show how the more liberal rules for clothing could increase the gains to these excluded countries by as much as a factor of five. Mauritius subsequently lobbied hard to become eligible for the less-restrictive rule.
6. See, for example, UNCTAD and Commonwealth Secretariat (2001).

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