

# In Search of Market Access: Why the Doha “Plan B” for December 2011 is likely to fail

## Erosion from Rules of Origin (Part II)

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Once again the Doha Round negotiators are struggling to reach an agreement, this time by mid-December 2011 on a “plan B” package that would give increased market access to the Least Developed Countries (LDCs) under simplified rules of origin (RoO). We argue that in spite of some simplifying reforms by the EU and the US, administrative costs associated with establishing origin will continue to be sizeable, approximately equal to the effective market access left under “plan B”. Given the reluctance in the past for OECD countries to simplify their RoO, the note concludes that the meeting the December package is unlikely.



A perceived lack of market access for the fifty Least Developed Countries (LDCs) resurfaces regularly during the Doha talks. Only a few weeks back, Pascal Lamy has, once more, tried to revive the negotiations with a “plan B” package that would deliver a first-phase agreement in December under an “LDC-plus” package whose pillar would be duty-free quota-free (DFQF) access and simplified rules of origin. In a previous note, using tariff data for the US and the EU, we showed that, once preferential access to competing countries in the form of Preferential Trade Agreements (PTAs) are factored in, LDCs have at most 3% actual preferential access margin in the EU and a negative preferential access in the US (meaning that some LDCs are discriminated against relative to their competitors on the US market). In this note, we argue that the administrative costs associated with complying with the origin requirements as embodied in the multiple rules of origin (RoO) both system-wide and at the product level (there are over 500 different Product-specific Rules of Origin (PSRO) in the case of the EU) takes away in the form of higher entry costs any remaining effective preferential access. Indeed, we give evidence that RoO are more stringent precisely on those tariff lines where market access is greatest suggesting that in the bargaining over their design, it is the lobbying interests in the preference-grantor countries that have the upper hand.

## ► Background

OECD countries use RoO to confer originating status for preference-receiving countries (these rules apply also for reciprocal preferential access). RoO are necessary to prevent trade deflection (i.e. importing from the low-tariff partner and then exporting to other countries in the preferential zone) for any Preferential Trade Agreement (PTA) short of a Customs Union. RoO are elaborate: they include regime-wide rules of origin and product-specific-rules of origin

(PSRO). Both are complex, particularly PSRO. Regime-wide rules include (i) a *de-minimis* (or tolerance) rule; (ii) cumulation; (iii) absorption (or roll up); (iv) duty-drawback provisions or their elimination; (v) origin certification procedures. PSRO are even more complex often including several cumulative requirements on a given Harmonized System 6 digits (HS-6) tariff line. An important observation is that LDCs who export rather similar products to different OECD countries face different RoO—both regime-wide but also PSRO—across destinations. Having to fulfill different requirements for exporting the same product to different destinations increases the overall costs of exporting under a preferential trade regime like the “Generalised System of Preferences” or “Everything but Arms”.

How much of the costs necessary to meet origin requirements are unavoidable? There is no quick answer to this question because of the diversity of product characteristics and more generally because the HS was not designed to conform to product characteristics. Hence using the HS to classify products is not very useful when it comes to identifying whether a product has met the requirement of “sufficient transformation” to qualify for preferential status. Indeed, it is partly for this reason that complex PSRO have been put in place. But, as the bulk of growing evidence shows, the design of these rules has been captured by private interests in the preference-granting countries or in the stronger of the two partners (e.g. the US in NAFTA) under reciprocal market access.

The complexity of the EU and US systems of PSRO has been summarized by an overall synthetic ordinal restrictiveness “R-index” that takes values in the range:  $1 \leq r_i \leq 7$  so that ( $r_i = 1$ ) corresponds to a PSRO that is easy to satisfy and ( $r_i = 7$ ) to one that is difficult to satisfy (as for example the triple-transformation rule under textiles & clothing (T&A) applied by both the US and EU whose average MFN tariff on T&A is around 10%). This R-index is based on an obser-



facing more restrictive RoO than the average preferential-receiving country of the sample. So LDCs are burdened both by stringent rules, and by unequal compliance costs to meet origin requirements. Additional evidence based on utilization of preferences points towards restrictive requirements where preferential margins are consequential. Cross-sectional evidence for Mexico under NAFTA on the correlates of utilization rates for preferences shows that, after controlling for the level of preferential access at the product-line level (higher preferential access is associated with higher utilization of preferences), utilization rates are lower for tariff lines that have higher values for the  $r$  index (see Carrère and de Melo, 2006)).

Finally, the African Growth Opportunity Act (AGOA) of the US presents an interesting quasi-experiment. As shown in figure 2a, under “Everything but Arms”, Sub-Saharan African LDCs had duty free access to the EU market throughout the period while for the US, these countries were confronted with the MFN tariff (almost the same value as for the EU) until AGOA was approved which also gave them duty-free access to the US market. Both the EU and US applied the triple-transformation PSRO for T&A<sup>1</sup>. Arguably, the most important feature of AGOA is that the US abandoned the triple transformation rule for the 22 AGOA beneficiaries (this is why it was called the AGOA-SR “Special Regime”). Figure 2b shows that the exports to the US of the 7 largest exporters shot up after elimination of the triple-transformation rule. Exploiting the timing of this change in RoO which did not occur at the same time for all countries, de Melo and Portugal-Perez (2008) estimate that, after controlling for the effects of changes in tariff preferential access, the application of AGOA-SR might have accounted for as much as an increase of 300 percent for the top seven exporters (however, some AGOA-SR receiving countries did not increase exports much).

1. The triple transformation rule requires that clothing be sewn from cloth originating in the preferential area, and that clothe be weaved from originating thread.

Figure 2a Preferential Margins to the EU (EBA) and US (AGOA)

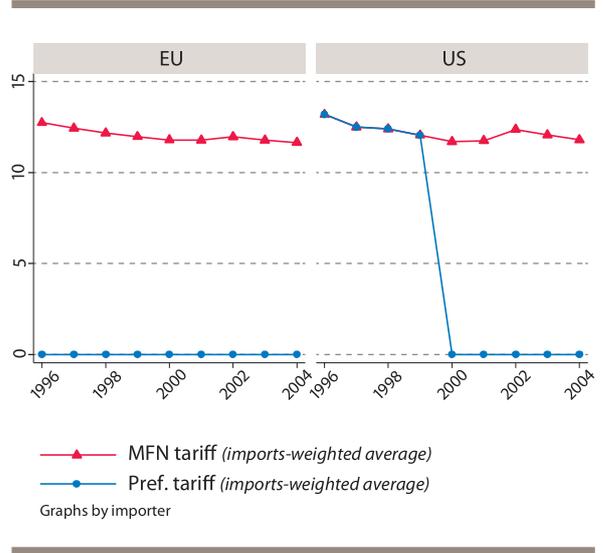
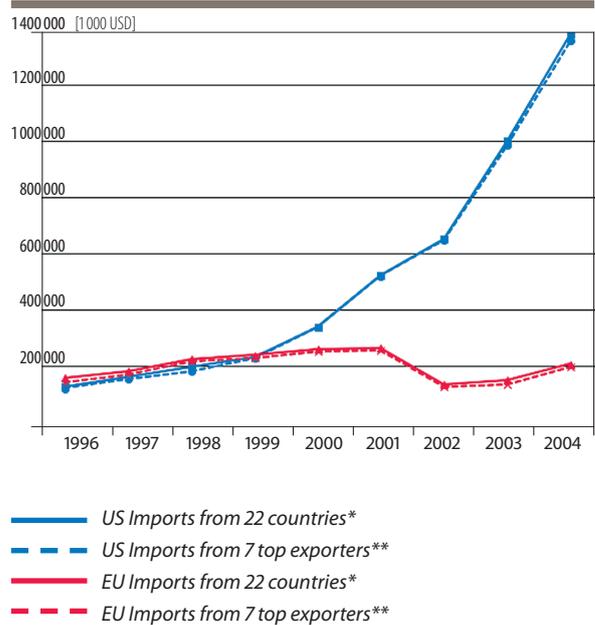


Figure 2b Apparel Exports to the EU and to the US from 22 countries under AGOA-SR



Source: de Melo and Portugal-Perez (2008)

## ► Some Progress, but not enough

Surveying the evidence from case studies and from econometric estimates, Cadot and de Melo (2008), conclude that the current system of RoO are:

- Complex, varying greatly in complexity across sectors
- Have administrative costs around 2-3 percent of sale price.
- More stringent for the products with the highest preference margins
- Different across countries for the same tariff line.
- PSRO are captured by lobbying interest groups

Under pressure from the experience of Sub-Saharan African exports under AGOA-SR, the EU finally abandoned the then prevailing triple-transformation for T&A when they negotiated the Economic Partnership Agreements with ACP countries in late 2007<sup>2</sup>. The EU also allowed for diagonal cumulation (i.e. inputs coming from a wider range of partners qualify as of domestic origin). Yet, a multitude of PSRO remain across the board for both the US and especially the EU, indicating that these countries are, in effect, resisting giving market access to LDCs.

What should be done—but will probably be resisted—is clear. First is *harmonization*. If taken seriously, LDCs would then face the same RoO at the HS-6 level whichever market they export to. Currently, this is not the case. Since it is known that compliance costs are higher for small firms, which represents the majority of LDC firms, the LDCs are already at a disadvantage as they have to deal with different RoO across destinations. This adds to export costs. Second, the PSRO system is in great need of *simplifica-*

*tion*. This recommendation extends beyond treatment to LDCs, applying to all preferential trading agreements. Such simplification might however end up being most helpful to the LDCs. One step in the right direction would be to establish simple and mutually consistent cumulation rules. The EU has set an example in this regard with the PANEURO system, precisely designed to facilitate cumulation across preferential zones. Another way to simplify the rules would be to use a single, across-the-board rule to foster transparency and mitigate capture. Clearly, technical requirements should be targeted for elimination in priority, being the most opaque, difficult to harmonize, and capture-prone instruments. Leaving aside agricultural products that could still operate under the ‘wholly obtained’ criterion, and keeping in mind that any uniform rule will affect industries and countries differently, two avenues could be considered: (i) a simple change of tariff classification, say at the subheading (HS 6) level so that it is not too restrictive; (ii) a uniform value-content (VC) rule.

The change of tariff classification has the advantage of simplicity, transparency, and low administrative costs. But the HS tariff nomenclature was designed to collect trade statistics, not to separate products and confer origin, so defining the change of tariff classification at a uniform level would produce erratic results across sectors. This would call for exceptions to uniformity, opening up the Pandora Box of special deals. Moreover, a change of tariff classification would not lend itself easily to differential treatment for LDCs, should that be an objective (see below).

As for a value-content rule, notwithstanding its conceptual clarity, it may be less than straightforward to apply in practice. It may increase producer risk due to the sensitivity of costs to exchange rate, wage and commodity-price fluctuations. It is also more burdensome to apply for customs officials. However, it is simple to specify, transparent, and allows for differential

2. There is, however, a limitation in the case of the Caribbean countries. The single-stage transformation only applies to knitted/crocheted fabric, not to woven fabric. For the other ACP countries, the single stage processing rule applies to all fabrics like in AGOA.

treatment of LDCs. All told, if specified properly it probably stands out as the best candidate for an across-the-board criterion, ideally in combination, at the exporter's choice, with a change of tariff classification.

Third *preferential* RoO should be applied to LDCs if high and middle-income countries are 'serious' about market-access. Here again, there are several possibilities. A simple first step in the reform would consist of eliminating RoO requirements for tariff lines with preferential margins below 3% or perhaps even 5% for all LDCs (the rate could be agreed upon and be a priority for the fast-lane negotiations for December 2011 under the "LDC plus" package). This would be an all-round winning proposition since resources would be freed for other purposes, especially in developing countries, but also for consumers in developed countries who would no longer bear part of the increased costs associated with compliance. A second step would be to allow for differential treatment not across sectors, but across beneficiaries, with full cumulation and low value-content requirements for LDCs reflecting the observation that the "slices" of value added performed in LDCs in cross-border production networks are generally thin (it is precisely for this reason that RoO in ASEAN where much trade along the value-chain takes place are simple and lenient, i.e. a 40% domestic value-content. Requirement used in conjunction with diagonal cumulation (Cadot et al. (2007)) It is remarkable that, so far, even the negotiations at the WTO to harmonize RoO for non-

preferential purposes have made little progress even though this harmonization would still allow countries to keep their currently complex web of RoO for PTAs. It is difficult to avoid the conclusion that this resistance to harmonization, let alone to simplification of RoO, bodes ill for the objective of reaching a simple and harmonized set of rules. Indeed, PSRO remain complex (with few exceptions such as ASEAN who apply a single VC rule) for all preferential trade agreements. One can only but conclude that agreeing to harmonize, simplify and give preferential RoO for LDCs for this December's deadline remains a tall order.

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