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PREFERENTIAL RULES OF ORIGIN

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Overview
Rules of Origin in East Asia: How Are They Working in Practice?

Mona Haddad, *EASPR, World Bank*

East Asia has moved from the rampant unilateralism of the late 1980s, during which external tariffs declined substantially, to the rampant regionalism of the 2000s that is creating a complex "Noodle Bowl" of preferential agreements (Baldwin (2005)). Until recently, regionalism in East Asia was limited to the ASEAN Free Trade Area (AFTA) which was established in 1992—tariff reductions were fully implemented by the six major ASEAN countries in 2003 while the lower-income ASEAN members received a longer time frame for implementation. Since 2000, however, new regional agreements have surged in East Asia. The ASEAN-China FTA was signed in 2002. Negotiations are also ongoing between ASEAN and several countries including Korea and Japan. The large countries of ASEAN—mainly Thailand, Singapore, Indonesia, Malaysia—are also contemplating or negotiating several FTAs (with US, Australia, Japan, and others). The increasing number of FTAs in East Asia and elsewhere is creating a complex web of multiple preferential tariff rates applied to various trading partners, often with varying timelines for reducing tariffs. It is also creating a complex and inconsistent web of rules of origin that often limit the use of the trade preferences.

Rules of origin are a necessary feature of any regional trade agreement. They ensure that preferences are available only to the signatories of the agreement and that imports from non-members do not avoid customs duties by entering through the member with the lowest tariff. The rules of origin define the amount of local processing, or the extent of the transformation of the product, that must be undertaken in the country from which the product claiming preferences is exported. The definition of these requirements to prevent "trade deflection" is not straightforward. If the rules are too onerous and complex and are costly to comply with, they will limit the impact of tariff reductions on trade. Indeed, import competing industries have often been successful in obtaining restrictive rules of origin that dilute the impact of the loss of tariff protection. This is most apparent in agreements between developed countries and lower wage countries. As FTAs multiply in the region, putting in place rules of origin (ROO) that are simple, transparent, and easy to implement becomes important. The experience in the implementation of the AFTA rules of origin can provide some lessons for the upcoming FTAs.

Rules of Origin in AFTA: How Are They Working in Practice?

AFTA preference utilization rates are low. ASEAN countries have implemented unilateral trade liberalization over the past two decades, and achieved low MFN rates (with average tariffs around 7 percent) by the time AFTA was implemented. This contributed to a limited impact of AFTA—today, less than 5 percent of intra-ASEAN trade makes use of the AFTA preferences. This is low compared with other FTAs. There are several reasons for the low utilization rates of AFTA: difficulty in *satisfying* the required value added requirement, difficulty in *proving* that the required value added has been satisfied, low preference margins, and high administrative costs of compliance. When the costs of complying with the rules of origin exceed the margin of preference then the trade agreement becomes irrelevant and trade will take place under the MFN regime.

The value added rule is simple in principle, but difficult to comply with. The AFTA rule of origin of 40 percent value added is simple and transparent, but it is proving difficult to implement in practice. AFTA members, especially CLMV countries, are often unable to cumulate the

necessary local/regional content. This is partly due to the high degree of production fragmentation in East Asia—half of its trade is in electronics and machinery where production networks are widespread. The import content (from outside ASEAN) of export is high, making it difficult to comply with the 40 percent valued added rule. Further, countries with low labor costs will find it more difficult to comply with a given value-added requirement than higher labor cost countries. The value added rule is also vulnerable to exchange rate fluctuations—any movement in the exchange rate leads to a change in import costs. This becomes problematic when the exchange rate fluctuations are widespread such as during the 1997 financial crisis. Moreover, the cost of proving origin is high. Computation of costs, invoicing, and other documentation demands inherent in the value added rule are complex, especially for smaller firms or firms from less developed East Asian countries.

The administrative cost of compliance to prove origin is a deterrent for the use of preferences. The complexity of administering and complying with the ROO exacerbates the problem. Surveys in a range of ASEAN countries highlight concern over the time and paperwork involved in obtaining Form D (official form to prove origin in AFTA), and the large amount of documentation required to prove origin (including invoices and other evidence to each input used in the final product). These problems are particularly acute for small firms and for firms for whom prompt delivery is a key element of competitiveness. The requirement that all Form Ds should be issued by designated government departments significantly increases the compliance costs compared to many other FTAs where private sector associations are permitted to issue certificates of origin. Estimates of the costs of requesting preferences within AFTA might be in the range of 10-25 percent—larger than those of other preferential schemes. Moreover, customs valuations differ across countries, pre-export inspections required by AFTA add to cost, transactions remain time-intensive and required face-to-face contact with officials, and incoming goods enjoying preferences are randomly subjected to post-audit checks.

Preference margins for products traded within ASEAN are low. Another reason for the low utilization rates of AFTA preferences is the low margin of preference on the products that are traded in large quantities within ASEAN, especially compared to the cost of compliance. Intra-ASEAN trade is dominated by computer/machinery and electrical equipment where the tariffs are very low (around 1.5 percent), making AFTA preferences largely irrelevant. Products with the highest margins of preference typically have a low value of import as a share of total intra-ASEAN trade such that the 40% value-added rule of origin is a binding constraint to preferential trade. This is known as the snow-plough effect—in the AFTA agreement, vehicles especially designed for traveling in snow are given a high preference margin, but are irrelevant for ASEAN trade. Moreover, countries that confer the highest margins also appear to impose non-tariff measures on these same products (such as quantity control measures on certain categories of vehicles).

The bulk of intra-ASEAN trade occurs in commodities where preference margins are below the threshold that would justify the cost of compliance. Estimates based on other FTAs show that preferences start to have a trade stimulating effect only when preferential rates are at least 25 percentage points lower than the MFN rates. Over 90 percent of intra-ASEAN4 (Malaysia, Indonesia, Thailand, Philippines) trade occurs in commodities where preferences are below 25 percent—the threshold for using the preference. Only about 8 percent of eligible trade flows have a preferential margin above 25 percent (and are therefore "worth using").

Moving Forward: What Is Being Done, What Can Be Done?

The value added rule could be relaxed—to 30 percent—especially for the less developed countries of ASEAN. ASEAN should stick to a simple and transparent ROO. Even though a value added rule is potentially costly for small firms in poor countries because of its requirements in terms of accounting, it has the advantage of being unambiguous and bypasses the need for product-specific rules, and does not leave leeway to lobbying by domestic industries over specification of rules. Analysis of data from the EU shows that a decline in the value-added requirement would tend to increase utilization rates. There a reduction in the maximum regional content from 60 percent to 50 percent is predicted to lead to an increase in the utilization rate by 2.5 percentage points (from the estimated mean of 17 percent) in the case of GSP and by 8.2 percentage points (from the estimated mean of 13 percent) in the case of ACP. Increasing utilization rates are likely to be most apparent for the low wage CLMV countries. The decision on whether to lower the value-added requirement should amount to an assessment of whether the potential gains in terms of greater regional trade significantly outweigh the risks of trade deflection. The analysis in these papers and the experience from elsewhere suggests that a 30% value-added requirement will be sufficient to prevent any significant trade deflection.

A CTC rule could be introduced in parallel to—not instead of—a value added rule. In order to ease the potentially cumbersome procedures involved in the valuation and certification of declared costs under the RVC rule, ASEAN members are considering shifting to the change in tariff classification (CTC) criterion for all products. This would be a good option if it is introduced as an additional choice to (and not instead of) the value added rule, is implemented as a common rule across products (for example change at the heading or 4 digit level) and if additional product-specific exemptions to the general rule are kept to a minimum. There are risks in such an approach that will need to be suppressed, especially if protection groups seek to increase the number of exceptions to the general rules and influence the specification of these rules by excluding inputs from certain tariff headings, attaching an essential process in the transformation of the product, or turning the value added rule as an additional instead of an alternative rule to satisfy origin. Bilateral FTAs with restrictive product specific rules will also most likely define the parameters of wider FTAs formed later on, as in the case of the Japan-ASEAN EPA. The advantage of introducing change of tariff heading as an alternative rule is that it is a rule that is very easy for Customs authorities to understand and implement, since they are dealing with issues of customs classification in their every day work. In addition, proving compliance can be easy for small firms since the presentation of the import and export invoices showing different customs codes at the heading level is likely to be sufficient.

Administrative procedures to obtain origin could be simplified. In order to ease delays and costs involved in proving compliance with ROO, self-certification can be introduced. This was proposed by Australia, Korea, China, and Japan in their respective FTA negotiations with ASEAN.

For FTAs such as AFTA which group countries with a wide variation in MFN tariff levels, avoiding trade deflection will always be a difficult challenge given the complexities of verifying the origin of goods produced or assembled from multiple locations worldwide. The burden of proper verification becomes all the more taxing in an environment where the proliferation of bilateral FTAs leads to numerous potential 'backdoors' that need effective policing. The likelihood of trade deflection increases when relatively high tariff countries like Thailand or the Philippines also acquire access to pockets of low barriers. This in turn might lead to more intensive or heavy-handed verification procedures that will further hike administrative and waiting costs. If implementation indeed becomes too difficult, leading to the inability to arrest a

significant amount of trade deflection, it may have a direct adverse consequence on the level of domestic political support for the FTA.

The lack of coordination in setting ROOs amidst the proliferation of FTAs has a political cost attached to it, namely the cost of choosing favorites among favorites. Different permutations in the exchange of concessions among countries result in ROOs with varying degrees of restrictiveness, which in turn lead to a hierarchy of partners not unlike the EU's so-called pyramid of preferences. Differentiating partners into friends, lesser friends, and foes has bred all sorts of animosities, and has not created an environment conducive to the development of closer or strategic economic partnership. The recent surge of FTAs in East Asia may be less about trade and more about issues like trade facilitation or regulatory barriers involving investments and services, where negotiations have bogged down in the multilateral arena. It is not unlikely that irritations stemming from contentious ROO negotiations, or the uneven restrictions applied to trade among different partners, could spillover to more important, high-stake negotiation areas.

Key lessons for future agreements include:

-Simple and transparent rules

-Give producers choice of methods to satisfy origin

-Ensure minimal costs of documentation

-Ensure minimal costs of implementation for Customs – perhaps raise spectre of customs have to deal with a multitude of different product specific rules of origin, different documentation etc

- Issue of cumulation in ASEAN but not in bilaterals being signed by ASEAN members, as this would increase the risks of hub and spoke with US, EU, Japan and maybe China.

PART I

RULES OF ORIGIN IN EAST-ASIA AND LESSONS FROM OTHER REGIONS

Chapter 1
Rules of Origin in East Asia

Robert Kirk, *The Services Group Inc.*

The consolidation of the multilateral trading system following the establishment of the World Trade Organization (WTO) in 1994 has been accompanied by the rise of regional preferential trade agreements (RTA). The Sutherland Report (2005) observes that the rise of RTAs has virtually reached the point where the core principle of non-discrimination embodied by the most-favored-nation (MFN) clause and the national treatment provisions which is integral to the WTO is now exceptional treatment or 'least favored treatment'. With more than half of total world trade taking place under RTAs and rising, and with new agreements being implemented, more attention is being focused on the impact of preferential rules of origin (ROO). ROO are now center stage in determining market access under RTAs.

ROO are a necessary feature of any form of RTA since they are required to ensure the preferences are available only to the signatories to the agreement. The sheer number of RTAs has resulted in a complex web of multiple preferential tariff rates being applied to various trading partners, frequently with varying timelines for reducing tariffs. Complex and inconsistent ROO—which often govern eligibility criteria of RTAs—have the potential to restrict effective market access and can prevent many of the RTA benefits from being realized. Recent work has focused on unscrambling the impact of rules of origin on economic welfare with studies on NAFTA, Latin America, and Southern Africa showing how complex preferential ROO result in increased transaction costs and limit the use of the trade preferences.[1] With the gradual accumulation of applied studies there is increasing evidence that the preferential ROO will reflect the specific protectionist interests of the more powerful partners in the preferential agreement (Moise, 2003).

Until recently regionalism in East Asia was limited to the ASEAN Free Trade Area (AFTA) which accounted for a small proportion of total trade. Since 2000, however, there has been an upsurge in new regional agreements with ASEAN and the larger ASEAN economies of Thailand, Singapore, Indonesia and Malaysia. Despite the AFTA and the rise of regional agreements the majority of trade in East Asia continues to take place on an MFN basis. This paper assesses the various ROO; examines the ROO within AFTA and their potential impact on preference utilization; and presents policy options for improving the ROO.

1 Preferential Trade Agreements and the Pattern of Trade in East Asia

In the mid-1990s economies in East Asia reduced tariffs unilaterally and sought to promote investment through the development of export processing zones, the widespread use of export duty rebates, and sub-regional cross border arrangements such as growth triangles. These incentives ensured that many exporters were entitled to import at preferential or duty free rates without using the evolving AFTA.

Following the Asian financial crisis of 1997-98 East Asian economies began to explore ways of increasing policy coordination and cooperation in trade and investment as a way of reducing the risks of financial contagion. At the same time there was a growing awareness within ASEAN of the importance of engaging more with China. Further the ASEAN private sector began to lobby for preferential access to regional markets. These internal pressures for increasing regional preferences have been buttressed by concern at the lack of substantive progress of the Doha

[1] The Origin of Goods, Cadot (2006); OECD, (2003); European Commission, (2003).

Round and the absence of momentum in the Asian Pacific Economic Cooperation (APEC) to advance the trade agenda. By the end of the 1990s many East Asian economies considered the negotiation of regional and extra-regional FTAs to be in their strategic interests.

Table 1: Major RTAs including countries in East Asia

Partners	Status	Year	Intra-Regional	Inter-Regional
Bilateral RTAs				
Singapore-Australia	Implemented	2003		X
Singapore-New Zealand	Implemented	2001		X
Singapore-Japan EPA	Implemented	2002	X	
Singapore-EFTA	Implemented	2003		X
Singapore-US	Implemented	2004		X
Korea-Chile	Implemented	2004		X
Japan-Mexico	Entered into force	2005		X
China-Thailand (agric.)	Entered into force	2003	X	
China-Hong Kong	Entered into force	2004	X	
China-Macao	Entered into force	2004	X	
Korea-Chile	Entered into force	2004		X
Thailand-India TIG	Entered into force	2004		X
Thailand-Australia	Entered into force	2005	X	
China-Chile	Entered into force	2005		X
Thailand-New Zealand	Entered into force	2005	X	
China-Pakistan	Entered into force	2006		X
Singapore-Korea	Signed	2005	X	
Korea-US	Signed	2007		X
Japan-Thailand	Signed	2007	X	
Japan-Malaysia	Signed	2005	X	
Japan-Philippines	Signed	2006	X	
Singapore-Jordan	Signed	2004		X
Singapore-Mexico	Under Negotiation	since 1999		X
Singapore-Canada	Under Negotiation	since 2001		X
Korea-Japan	Under Negotiation	since 1998	X	
Japan-Indonesia	Under Negotiation	since 2005	X	
Japan-Vietnam	Under Negotiation	since 2006	X	
Thailand-US	Under Negotiation	since 2004		X
Thailand-EFTA	Under Negotiation	since 2005		X
Thailand-India	Under Negotiation	since 2004		X
Thailand-Peru	Under Negotiation	since 2004		X
Thailand-Bahrain	Signed FA	2002		X
Korea-New Zealand	Joint Study	2000		X
Korea-Thailand	Joint Study	2001	X	
Japan-Chile	Joint Study	2000		X
Korea-Mexico	Discussion (halted)	2000		X
Korea-Australia	Discussion	2000		X
Japan-Canada	Discussion	2000		X
Plurilateral FTAs				
AFTA	Implemented	1992	X	
Chile-NZ-SGP-Brunei	Entered into force	2000		X
ASEAN-Korea TIG	Signed	2002	X	
ASEAN-India	Under Negotiation	since 2003		X
ASEAN-Australia	Under Negotiation	since 2004		X
ASEAN-China	Signed FA	2001	X	
ASEAN-Japan	Framework Agreement	2002	X	
China-Japan-Korea	Joint Study	2001	X	
ASEAN-CER	Ministerial Declaration	1999		X
ASEAN-3	Discussion	2000	X	

Source: Agreements and www.bilaterals.org

By 2007, Asian countries (excluding China) had ratified 13 bilateral and regional FTAs and had negotiated (but not implemented) another seven (Table 1). Many more bilateral and regional FTAs are currently being actively negotiated by Asian countries—many of these are with non-Asian partners. Thailand entered into Bilateral Trade Agreements with Australia and New Zealand in 2004 and 2005 respectively. It has recently concluded negotiations with Japan and is currently engaged in negotiations with Bahrain, EFTA, India, Peru and the US. The Philippines signed an agreement with Japan in 2006, while Korea, Indonesia, Vietnam, Laos and Cambodia are currently still negotiating with the latter. Over the past six years China has negotiated an FTA with ASEAN and has completed five bilateral FTAs—with Thailand in 2003 (for agricultural produce), Hong Kong and Macao in 2004, Chile in 2004 and Pakistan in 2005. China is currently negotiating or initiating another 17 bilateral and regional FTAs. ASEAN has further signed initial agreements with Australia and New Zealand, and with Japan. It is currently negotiating with India and South Korea (a "Trade in Goods" Agreement between Korea and ASEAN is already in place). Of the 18 agreements currently in effect, 7 involve only East Asian countries and the remaining 11 are bilateral or trilateral agreements between an East Asian country and a country outside the region.

AFTA. The ASEAN Free Trade Area was established in 1992 between the six ASEAN member countries—Indonesia, Malaysia, the Philippines, Singapore, Thailand and Brunei—with the objective of increasing their international competitiveness by lowering intra-regional tariffs. Through the Common Effective Preferential Tariff (CEPT) scheme, tariffs would be reduced to 0-5 percent within a 15-year period. By 2003, after only 10 years, AFTA succeeded in reducing average tariff rates from 11.4 percent in 1993 to 2.4 percent for the original ASEAN-6. The new ASEAN members—Cambodia, Laos, Myanmar and Vietnam (CLMV)—joined AFTA in the latter half of the 1990s and committed to removing tariffs over a longer time period.

The AFTA approach to free trade is complex with countries only receiving preferences for items on both the counterparty's Inclusion List as well as items on their own Inclusion List. Consequently all products on both offering countries (and offers are made bilaterally and not to all ASEAN members) in the Temporary Exclusion, General Exception and Sensitive Lists are not offered tariff preferences. About 95 percent of tariff lines are in the Inclusion List. But this fractured approach means that the degree of market access faced by an AFTA exporter of any specific product could vary according to the specific ASEAN market. ASEAN has agreed to systemic rules of origin, product exclusion practices and phase-in modalities.

Table 2: AFTA CEPT rates and distribution of tariff lines 2003

Country	CEPT	Inclusion List	Temporary Exclusion List	General Exception List	Sensitive List
Brunei Darussalam	1.04	96.7	0.0	3.1	0.2
Indonesia	2.17	98.9	0.0	0.9	0.2
Malaysia	1.95	96.6	2.1	0.5	0.8
Philippines	3.82	98.6	0.0	0.3	1.2
Singapore	0.00	100.0	0.0	0.0	0.0
Thailand	4.63	99.9	0.0	0.0	0.1
ASEAN -6	**2.39**	**98.4**	**0.5**	**0.8**	**0.4**
Cambodia	7.94	45.7	51.6	2.0	0.7
Lao PDR	5.86	59.1	36.4	2.1	2.5
Myanmar	4.61	65.4	33.3	0.9	0.4
Vietnam	6.43	86.1	10.9	2.2	0.8
New Members(CLMV)	**6.22**	**64.3**	**33.0**	**1.8**	**0.9**
ASEAN-10	**3.33**	**87.1**	**11.2**	**1.1**	**0.6**

Source: ASEAN Secretariat

ASEAN+China. In November 2000 ASEAN and China agreed to establish a free trade area and concluded a Framework Agreement in 2002. This committed both parties to establish an FTA by 2012. Two way ASEAN–China trade had increased rapidly and by 2000 reached $39.5 billion to account for 8.3 percent of China's foreign merchandise trade. ASEAN is now China's fifth largest trading partner and a major supplier of raw materials, as well as textiles, metal and metal products, leather and leather products, chemicals, electronic components and plastics. Bilateral trade with China represents just 3 percent of total ASEAN exports and 5 percent of ASEAN imports (based on trade with the ASEAN 6).

Under the ASEAN-China agreement, China will establish an FTA with the original ASEAN 6 by 2010 and with the newer ASEAN members by 2015. Like AFTA, the ASEAN-China FTA is complex with each party selecting their own sensitive list and bilateral market access depends upon the interaction of the offers of the two countries. The ASEAN FTA with China is effectively 10 FTAs as each member of ASEAN submits a country specific offer to China which then prepares an offer for each country. Preferences are offered on a reciprocal basis so will only apply to those specific products that are included in both countries' lists. The rules of origin are identical to the AFTA ROO although there is a provision for these to be negotiated 'between the parties'.

The Early Harvest program, which cuts tariffs on eight categories of agricultural products (about 600 different tariff lines), also uses the existing ASEAN ROO. The Early Harvest tariff reductions to zero were to be in place for the original ASEAN members by 2006 and for the CLMV by 2010. The Philippines elected not to participate in the Early Harvest Program arguing that their agricultural sector would be adversely affected. Two-way trade between China and ASEAN increased by 40 percent in 2003 and this trend has continued.

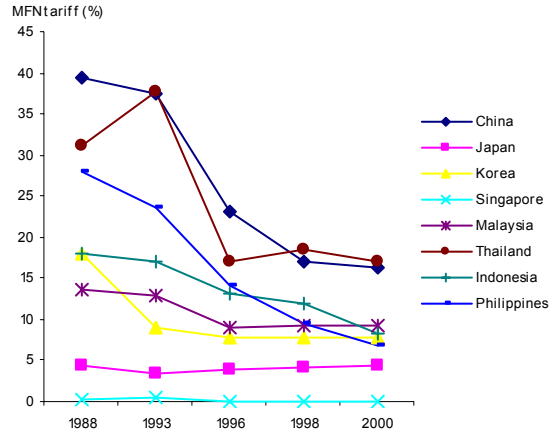
2 AFTA Utilization of Preferences

ASEAN countries have implemented a unilateral trade liberalization over the past two decades and achieved low MFN tariff rates by the time AFTA was implemented (Figure 1). This contributed to the limited impact of AFTA—although AFTA implementation is measured in terms of the number of tariff lines that have been either partially or fully liberalized, less than 5 percent of total intra-ASEAN trade takes place under the CEPT. Thus 95 percent of intra-ASEAN trade found it more beneficial to either pay the MFN tariff or take advantage of other schemes such as the duty drawback programs or duty-free treatment in the EPZs. At the country level, only 11 percent of Thailand's imports from ASEAN took advantage of the CEPT while only 4 percent of Malaysia's AFTA exports benefited from preferences in 2002.

The reasons for the low utilization rates are straightforward: AFTA's margin of preference on the products that are traded in large quantities are too small to compensate for the administrative costs of applying for preferential tariff treatment. Intra-ASEAN trade is dominated by computer/machinery (HS chapter 84) and electrical equipment (HS chapter 85) where the tariffs are very low—1.5 percent and 1.4 percent, respectively—and AFTA preferences not relevant (Figure 2). Recent work on both the EU and NAFTA indicates that when the preferential margin drops below 5 percent traders choose to use the MFN because the compliance costs tend to exceed the preference.[2] In the case of AFTA the margins of preference are below 5 percent for most ASEAN countries, and thus traders find it more advantageous to use the MFN tariff.

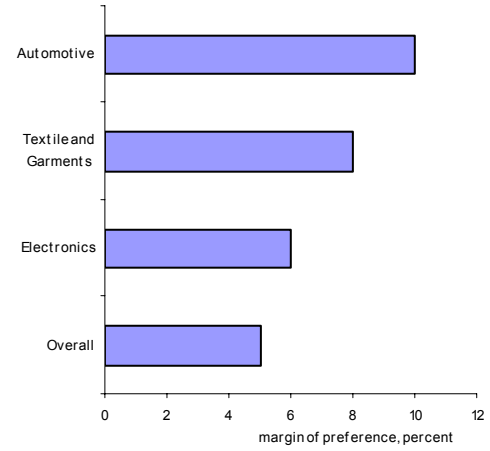
[2] See Cadot et al (2005) which estimates the compliance costs associated with the rules of origin under NAFTA and the PANEURO at 6.8 and 8 percent of the value of the product respectively.

Figure 1: Average tariff rates in East Asian countries



Source: ASEAN Secretariat

Figure 2: AFTA margin of preference (difference between MFN rate and CEPT rate)



Source: UN-COMTRADE, 2004

The complex sourcing of inputs from across South East Asia and elsewhere to produce a finished product for export to the region and major developed markets requires an efficient trading system where components and intermediates can be sourced at world price (or close to world prices) with timely delivery and low trade facilitation costs. Transnational corporations will be continually reviewing their sourcing policies to purchase from the most efficient suppliers. To date this has developed independently of the AFTA and the ROO governing the CEPT. However, ongoing trade negotiations may result in changes to the ROO that have implications for the sourcing of inputs by 'Factory Asia'.

3 Preferential Trade Agreements and Rules of Origin

Rules of origin are necessary within a preferential trade agreement to prevent trade deflection or trans-shipment, which occurs when goods enter through a low duty country and then are shipped to a higher duty country. Preferential ROO aim to ensure that only goods originating in the participating countries (i.e. the members) receive the preferences.

Products that meet the ROO criteria are referred to as 'originating' in a member country and will generally qualify for the preferential tariff rates. The standard procedures for administering ROO are set out in the Kyoto Convention (1977) on the Simplification and Harmonization of Customs Procedures. This states that ROO should, *inter alia,* be objective, understandable and predictable, and be capable of being administered in a consistent, uniform, impartial and reasonable manner. ROO can be designed to achieve a specific commercial policy objective, such as protecting existing regional producers of intermediate or final products. The impact of ROO on production costs stems from the technical criteria imposed by the ROO regime. If the ROO result in an increase in the cost of intermediate goods from the pre-RTA levels there is the potential for trade diversion in intermediates within the RTA.

There are two broad types of ROO. Either a good consists entirely of inputs from member countries in which case it is deemed *wholly obtained* or *produced and qualifies*, or the product uses a combination of member inputs and imported inputs. In the latter case it is necessary for the product to be 'substantially transformed' in order to qualify. The way in which 'substantial

transformation' is defined determines the economic impact of the ROO and in turn the relevance of the RTA to the members.

'Substantial' transformation can be defined in a simple transparent manner in order to meet the authentication requirement that the product has been finished in the originating country. It is possible to list a small number of rudimentary 'screwdriver' activities that are deemed as not eligible in order to prevent circumvention. This generally covers activities such as mixing, cleaning, washing, and repackaging. However, when ROO accompanying many RTAs are examined, it is clear that the trade negotiators eschewed a 'simple' approach in favor of crafting more arcane requirements. In many RTAs the ROO run to several hundred pages and in some well-known cases one product can require up to twenty pages of description.[3] Even relatively simple products can have astonishingly complex ROO.[4] A priori, a 'simple' ROO is not necessarily less restrictive than a more 'complex' ROO.

Practical approaches to ROO. There is no unique approach to defining originating criteria. In practice between one and three approaches can be used either on their own or in any combination with each other:

- Change in Tariff Classification (CTC) between the manufactured good and the intermediate inputs used in the process from countries outside the RTA. The CTC may require the product to alter its chapter (two digits at the HS level), heading (four digits), sub-heading (6 digits) or item (8-10 digits) in the exporting country. The ROO may attach Exceptions (EX-out) to a particular CTC –these generally prohibit the use of non-originating materials from a specified subheading, heading, or chapter;
- Value Content (VC) requires the product to acquire a certain minimum local value in the export country. The value content is expressed in one of three ways-as the minimum percentage of value that must have been added in the exporting country (domestic or regional value content, RVC), as the difference between the value of the final good[5] and the costs of the imported inputs (imported content), or as the value of the parts where originating status is given to products meeting a specified minimum percentage of originating parts as a proportion of the total;
- Technical Requirements specify the production processes that must take place or prescribes or prohibits the use of certain inputs. This is widely used for apparel producers.

In addition to the product-specific requirements for substantial transformation each RTA ROO typically contains general rules. These may include:

[3] The NAFTA product specific ROO exceed 300 pages of text. For a sector example refer to the ROO for motor vehicles under the NAFTA Agreement http://www.cbp.gov/nafta/docs/us/chap04.html#A403 For a summary of the negotiations on motor vehicles under the NAFTA refer to Negotiating NAFTA, Robert Maryse (2000)

[4] Brenton and Imagawa (2004) cite the case of the EU ROO for fish under the Cotonou Agreement. This requires that the fish be caught in the territorial waters of an eligible (ACP) country, and when landed at an EU port the ship should carry documentation establishing that the vessel's captain, officers and at least 50 percent of its crew were nationals of an EU or ACP state, the ship is registered in an EU or ACP state, it sailed under the flag of an EU or ACP state, it was at least 50 percent owned by nationals of an EU or ACP state (although there are certain exceptions for leased and chartered vessels), and the chairman and the majority of the board members of the company owning the vessel were nationals of an EU or ACP state.

[5] It is important to note whether the price refers to cost or production or ex factory price (i.e. the sale price)

- *De minimis* allows for a specified maximum percentage of non-originating materials to be used as though they were originating. This provides some flexibility in the CTC and Technical Requirements by making it easier to use non-originating products;
- The roll-up or absorption principle allows for initially non-originating inputs that have acquired origin through meeting specific processing requirements to be deemed as originating when they are used as inputs in a subsequent transformation;
- Cumulation allows for producers in one RTA country to use materials from another RTA country (or countries) without losing the preferential status on the final product. This concept is particularly important when considering the impact of multiple RTAs. There are several different types of cumulation. *Bilateral cumulation* functions between two RTA partners and permits them to use products that originate in the other RTA partner as if they were their own when seeking to meet the ROO. Under *diagonal cumulation*, countries in the same RTA can use products that originate in any part of the common ROO zone as though they had originated in the exporting country. *Full cumulation* is more flexible than diagonal cumulation as it allows countries tied by the same ROO regime to split the intermediate processing between the parties to the RTA and be granted the preference as long as when all the materials and processing used are added they are sufficient to meet the ROO;
- A separate list of activities or processes which are considered insufficient to confer origin; this may include cleaning, sorting, marking, labeling;
- Explicit prohibition on the use of duty drawback which rules out the refunding of tariffs on non-originating inputs that are used as inputs into the final product. Many countries use duty drawback or duty rebates as an investment incentive for exporters; however, in the case of a RTA this is considered to provide a cost advantage to the RTA-based producers for export compared to the producers for the domestic market. Many duty rebate schemes require the producers to export a minimum of 80 or 90 percent of their total sales.
- The procedures for certifying the origin of the goods can potentially impose high administrative costs on exporters. Common certification methods are self-certification by exporters, certification by the exporting country government or an industry umbrella group that has been accorded responsibility for issuing the certificate. Cumbersome and time-consuming certification requirements increase the costs of compliance and reduce the incentives to use the RTA.

ROO vs. local content schemes—what is the difference? ROO are used as instruments of trade policy with trade negotiators expending substantial time and energy carefully crafting both the general rules and the specific criteria for substantial transformation. ROO may be considered as analogous to content protection or local content schemes. These schemes may be considered as a type of proportionally distributed quota in which duty-free (or at preferential rates) imports are permitted in some specified proportion to purchases from domestic producers. The local content scheme requires that domestic final good producers purchase a specified minimum proportion of their intermediate goods from domestic firms. ROO extend this to apply to sourcing either locally or from member countries of the RTA. The literature on local content schemes has shown convincingly the harmful economic impact.

In fact, ROO are more complex than local content schemes since firms are permitted to source from within the RTA and *a priori* it is impossible to define if the ROO are restrictive or not. Any ROO that results in producers and investors modifying their sourcing behavior compared to what would prevail without the RTA is restrictive. This may apply to ROO that are 'simple'. Indeed a ROO that is binding for one country may be irrelevant for another member of the RTA. For example, a country with substantial resources and a diverse manufacturing base will *ceteris*

paribus be able to comply with ROO relatively more easily than a small economy with a narrow specialized manufacturing sector.

Measuring the restrictiveness impact of ROO. In order to assess the degree of restrictiveness of ROO, Estevadeordal and Suominen (2006) develop a 'facilitation index', which seeks to summarize information on regime-wide rules. Quantifying non-tariff barriers is fraught with difficulties but when conceptualized in terms of tariff equivalents it becomes easier to assess their economic impact. ROO are a particularly difficult form of non-tariff barrier to classify because their impact cannot be known ex ante. The approach taken by Estevadeordal is to classify ROO according to their administrative types, make prior assumptions about the restrictiveness of each type, and assign an index between 1 and 7 in order of increasing restrictiveness of each type (Table 3). There are three main types of ROO: change of tariff heading (CTH) or change of tariff classification (CTC), value content and technical requirements. These are not mutually exclusive with some products requiring a combination of the different types.

Table 3: Index of restrictiveness of rules of origin

Index of Restrictiveness	Description
1 (least restrictive)	CTC at the level of HS 8 -10 digit
2	CTC at the level of subheading HS 6 digit
3	CTC at subheading plus value content
4	CTC at the level of heading HS 4 digit
5	CTC at the level of heading and value content
6	CTC at the level of the Chapter HS 2 digit
7 (most restrictive)	CTC at the level of the Chapter and Technical Requirement

Source: Estevadeordal et al in Cadot (eds.) 2006.

While the restrictiveness assumptions made by Estevadeordal and Suominen to come up with the restrictiveness index are plausible, a problem which they note is that the HS coding system was not designed as a policy implementation tool for ROO. As experience has shown in a number of RTAs, a change of chapter requirement in most agricultural or primary commodities might be much easier to meet that even a change in subheading in some chemical, electrical or mechanical goods sectors where inputs and outputs are often included in the same subheading.

While changes in tariff chapters, subheadings and headings may seem to be relatively straightforward, how should technical and value requirements be categorized? Is a technical requirement more or less restrictive than a restriction on import content? And if there is both a technical and value-content requirement in a sector, is that more restrictive than only having a technical requirement or a stand-alone value requirement? The answer cannot be known ex ante and will depend at least in part on the nature of the technical requirement and on the amount of import content allowed under the value requirement. When there are two requirements, the answer depends on which one is binding for producers or potential regional exporters in the sector. The restrictiveness of any given requirement will vary according to the sector in which it is applied. Yet, in the index a 60 percent local content requirement receives the same restrictiveness index as a 40 percent requirement and almost certainly the impact will be very different.

Great caution is needed in interpreting the restrictiveness impact of different ROO across sectors. Uniform ROO across all sectors will impact those sectors asymmetrically. ROO that are different across sectors may not easily show the extent of their restrictiveness—ROO that show many sectors with extremely 'liberal' ROO may not indicate an increase in market access under the RTA; in such cases the 'strict' ROO may only apply to few sectors, but these may be the protected ones with potential trade creation. The variation in the ROO may be evidence of 'made

to measure' protection aimed at ensuring the partner countries are unable to compete with the existing import substituting sector.[6]

4 The ASEAN Rules of Origin

The ROO for the ASEAN Free Trade Area (AFTA) originally applied a single method for all products, namely value added. Under AFTA, originating status is conferred under either one of two conditions:

(a) products wholly produced or obtained in the exporting Member States as defined in Rule 2,[7] or
(b) products not wholly produced or obtained:

> *(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.*
> *(iii) Subject to sub-paragraph (i) above, for the purposes of implementing the provisions of Rule 1 (b), products worked on and processed as a result of which the total value of the materials, parts or produce originating from non-ASEAN countries or of undetermined origin does not exceed 60 percent of the FOB value of the product produced or obtained and the final process of manufacture is performed within the territory of the exporting Member State.*

The ASEAN ROO provide for full cumulation where the imported input is wholly originating and partial cumulation in all other cases subject to a minimum threshold of 20 percent. In cases where the imported input does not meet the ROO (i.e., less than 40 percent local/ASEAN content) but the local/ASEAN content exceeds 20 percent, the intermediate input will not receive the CEPT preference but must complete a Certificate of Origin (referred to as a Form D) in order to be used for cumulation. These implementation guidelines were agreed at the ASEAN Economic Ministers' Retreat in April 2005.

Provision is made for products to transit through a non-ASEAN country subject to it being 'justified for geographical reason or by consideration related exclusively to transport requirements'.

The ASEAN ROO does not mention the treatment of duty drawback or the Absorption or Roll Back principle.

The AFTA does not require a Form D for small scale cross border trade, defined as less than $200.

[6] This was the case in SADC where South Africa negotiated more stringent ROO for those sectors in which had a commercial interest (see Erasmus et al, 2006).
[7] Rule 2 includes the definition of wholly produced products within a Member country which includes mineral products extracted from its soil, products obtained by hunting or fishing there, products of sea fishing and other marine products taken from the sea by its vessels, agricultural products harvested there.

To qualify for the CEPT the products require a Certificate of Origin issued by a government authority designated by the exporting Member State and notified to the other Member States in accordance with the Certification Procedures that are approved by the Senior Economic Officials Meeting (SEOM). ASEAN Member States have approved Operational Certification procedures for the issuance and verification of the Certificate of Origin (i.e. Form D).

Box 1: **Obtaining a Form D in Vietnam**

In Vietnam, the Export-Import Managing Department of the Ministry of Trade is the issuing institution for Form D.

An application is submitted to an inspection company authorized by the Ministry of Science to conduct a cost screening to ensure local content of 40 percent or more. VINACONTROL remains the largest inspection firm, but the number of authorized companies has increased over the past few years. This provides for competition. Screening generally takes between one-half to a full day.

The applications required for each shipment are submitted to a branch office of the Export-Import Managing Department (9 Branches nationwide) and are accompanied by a certifying letter from the inspection company, a commercial invoice, a Customs declaration form, a bill of lading, and a copy of the exporter's commercial license. Form D is issued within 2 hours.

Form D can only be issued by Government authorities, unlike many FTAs where certificates of origin can be issued by private sector agencies such as Chambers of Commerce. In order to receive a Form D the exporter must apply in writing to the relevant government authority requesting pre-export verification of the origin of the products (see Box 1 for the Vietnam example). In the case of locally procured materials (i.e. Rule 1) the final manufacturer is entitled to complete a self-declaration. Rule 6 of the operational guidelines requires 'the Government authorities to … carry out proper examination upon each application for the Certificate of Origin'. The operational guidelines are very thorough and appear to have been drafted to facilitate the use of ROO.

The AFTA ROO are simple but implementation shows that meeting a 40 percent value added is difficult, especially for CLMV countries. The basic rules of origin adopted by ASEAN for the AFTA are simple and transparent, with a requirement that Members must source at least 40 percent of the value of the ex factory price from ASEAN. However, once Members began implementing this basic ROO, concerns were raised about the difficulty of meeting the 40 percent local content. This ROO was especially difficult for the CLMV countries to meet outside of agricultural commodities. Data on aggregate value added as a percentage of total output (in domestic prices) across sectors and countries show very few sectors with a value added above 40 percent (Table 4).

Table 4: Value added as proportion of total costs (in percent)

Industrial Sector	Cambodia	Indonesia	Laos	Philippines	Thailand	Vietnam
Processed Meat/Fish/Vegetables	25	25	68	35	16	11
Wearing Apparel	51	44	25	52	30	40
Leather Processing	7	23	-	48	21	41
Wood Processing	37	56	10	45	25	18
Paper and Paper Products	78	44	6	41	23	21
Basic Chemicals	60	26	41	30	14	21
Rubber Products	65	24	30	37	20	28
Glass Products	60	-	62	56	36	47
Basic Iron and Steel Products	64	28	52	33	13	20
Metal Products	49	35	34	41	-	25
Electrical Motors	76	56	12	33	28	37
Motor Vehicles/Auto	35	50	33	30	11	34
Furniture	75	39	-	48	34	31

Note: Laos and Philippines 1999, Cambodia, Thailand and Vietnam 2000 and Indonesia 2002
Source: Derived from Value Added Surveys from UNIDO.

It is also vulnerable to exchange rate fluctuations. One of the fundamental problems with a ROO based on value added criteria is that uncertainty is created when import costs fluctuate. The widespread fluctuations in exchange rates during the 1997 financial crisis—when many currencies in ASEAN countries depreciated by more than 20 percent against the US dollar and other major OECD economies—illustrate the vulnerability of the value added criteria as a basis for defining eligibility. For example, if a CEPT eligible exporter imported 55 percent of his inputs from the US and the dollar appreciate by 20 percent against the ASEAN currency (assuming that the domestic costs remained unchanged), the exporter would no longer meet the ROO since his import content would now be 66 percent.

The cost of compliance with the ROO is a deterrent for the use of CEPT, especially given the low MFN tariff rates in ASEAN countries. The cost of compliance with the ROO is a major factor influencing companies' decision on using the CEPT rather than MFN. A survey by JETRO finds that a number of companies had concerns over the time and paperwork involved in obtaining the Form D. Producers complained about large amounts of documentation required since it is necessary to attach invoices and other evidence to each locally procured part (input) used in the final product. One automobile producer in Thailand stated

"*The preparation of documents for the initial cost screening takes two months and the screening procedures themselves about one month. There are 1,000 to 2,000 parts in a completed vehicle, and we must collect documentation (invoices, Form Ds, etc.) certifying local procurement from each supplier"*

Firm level interviews and the recent ASEAN Review of Competitiveness undertaken by McKinsey (2003) find evidence that the compliance costs of the AFTA ROO were not trivial. The McKinsey study concludes that the process for administering the ROO was 'extremely cumbersome to companies'. It reports how the Consultative Committee for the CEPT had evidence that Form Ds were rejected at customs, often for fairly innocuous reasons such as a blurred signature or a mistake over the rightful signature required to certify the Form. The requirement that all Form Ds can only be issued by designated government departments significantly increases the compliance costs compared to many other FTAs where private sector associations are permitted to issue certificates of origin.

ASEAN has been flexible and quick in resolving some issues related to ROO. Initially there was a minor technical problem in that to obtain a Form D it is necessary to have an HS code. However, the listed HS Code is not compatible with the import country code which is more detailed. The adoption of the ASEAN Harmonized Tariff Nomenclature (AHTN) in 2004 resolved this problem.

ASEAN also adjusted to the fact that there is a growing trade in intermediate inputs between Member countries and third countries. The original CEPT scheme assumed that most of the trade would be sent directly from Country A to Country B since there was no provision for using intermediaries. However, there is a growing trade between ASEAN members through an intermediary in a third country. In such cases the shipper price and the FOB price may well differ on the invoice and Form D, and Customs officials in the importing countries may not accept the Form D. This problem was addressed at the AFTA Council Meeting in September 2003 which permitted the Form D issued on the basis of an invoice submitted by a company in a third country to be accepted by an importing country. This, however, does not provide for certainty when using a third party, as the details for completing the Form D were not specified. For example, Thai Customs require 'the invoice price must be the same or higher than that listed on Form D'.

The CEPT rules recognize the importance of trade in intermediates and inputs between three ASEAN countries—Malaysia, Singapore and Thailand—where the goods are imported from one ASEAN country and re-exported to a third ASEAN country. An administrative arrangement referred to as a Back-to-Back Form D is in place to accommodate such trade and is only applicable to these three countries. It is based on the original Form D but takes account of the fact that Singapore is a Hub. Both Malaysia and Thailand require the original Form D to be submitted along with the Back-to-Back Form D for imports.

5 Comparing ASEAN ROO with Other FTA ROO

The WTO Secretariat reviewed the ROO agreements in 93 Regional Trade Agreements in force in March 2001 (Annex B). The Agreements are organized into three broad categories: (i) the PANEURO system, (ii) the United States, and (iii) those involving the Pacific and Asia. Both the US and the EU approaches are characterized by product-specific ROO that are complex and more restrictive for labor-intensive products that are characterized by fragmented (or roundabout) production processes—for example garments.

The Pan European system of cumulation of origin (PANEURO) applies to 50 agreements. These are FTAs within Europe and involving EU states and third parties. Within the PANEURO system (i) semi-finished inputs which originate in any country in the system and which are further processed or assembled in any country in the system may always be considered as originating products; (ii) originating products can be traded between any of the countries in the system, and there is a tolerance rule for third country materials. The PANEURO system simplifies the procedures since once a product has been accorded 'European Origin' it is not necessary to verify the origin again and there is more freedom in using inputs or deciding in which country to locate the production facilities.

The three different origin criteria are all widely used in RTAs. The most common is the CTC, but it is also common to use at least two methods for conferring origin. While the CTC and the percentage local content methods are generally spread across all HS Chapters, the technical test is generally used for some industrial products such as textiles. CTC generally operates at the HS Heading level (i.e. four digits). In specific cases the CTC rule permits the use of materials classified under the same heading—such exception may limit the values that can be used or may specify that change is required at the subheading (NAFTA follows this approach). Virtually all the agreements contain a tolerance rule.

The use of import content criterion—which imposes a ceiling on the use of imported parts—is more common than the calculation based on domestic content. PANEURO is based on the import content method. On average it appears that domestic content varies for 40 percent to 60 percent and import content from 60 percent to 40 percent. However, much more liberal ROO have been agreed in the Western Hemisphere with the Canada-Chile FTA requiring domestic content of 25-35 percent and COMESA requiring 35 percent or CTC. The WTO noted that in recently concluded RTAs the technical test criterion stands out as the most common method for meeting the ROO and is widely used in textiles and chemicals. Moreover, in most cases positive tests are also used.

The US preferential agreements and FTAs develop ROO based on Change of Tariff Classification, except for those tariff lines where substantial transformation cannot be ascertained from CTC. In these cases the CTC rules are supported by regional value content test. Prior to Australia negotiating the FTA with the US they used value content ROO in their FTAs. During

their negotiations with the US it was clear that in order to reach agreement they would have to agree to CTC rules of origin supplemented with detailed technical explanations in many cases. All the FTAs currently under negotiation with the US follow the CTC approach and other countries in the Asia-Pacific region are adopting the same basic approach.

Experience from existing ROO shows that the CTC approach is superior. The main advantage of the CTC approach is its objectivity—there is a single transparent and clearly defined rule for each tariff line. The exporter does not have to factor in exchange rates, fluctuating input prices, discussions with customs officials over allowable and non-allowable costs, or the allocation of operating overheads across production.

It is often assumed that clear value added criteria for ROO, like the AFTA, are simple and easy to comply with compared with the lengthy and detailed product-specific ROO that apply in the case of the US FTAs. Experience of producers and traders points to a contrarian finding—namely that CTC and product-specific ROO may be more liberal and less costly to comply with. Indeed, in isolation the CTC is a more predictable approach, is easier to administer, and imposes fewer compliance costs on firms. This makes it more attractive for small and medium enterprises to comply.

Unfortunately the CTC approach provides scope for countries to propose product-specific rules that often seek to produce trade restrictive outcomes in order to preserve their existing levels of effective protection while selectively removing tariffs. For example, the 'yarn forward' rules adopted in NAFTA and a number of FTAs require fabrics produced for export to consist of yarns wholly formed in one or other of the Parties to the FTA, and that apparel for export be produced from fabrics entirely formed in one or other of the Parties using yarns wholly formed in one or other of the Parties. These rules are often difficult to comply with.

6 Preferential Rules of Origin and Regional Integration in East Asia

The increase in the number of FTAs recently signed or under negotiation by individual members of ASEAN with third countries is resulting in differing ROO being agreed for the same commodity or product. Bilateral FTAs have been signed between ASEAN members, primarily Singapore, and non-member countries with different rules of origin than those applied in ASEAN. The Singapore-Japan free trade agreement uses all three methods of determining origin (Annex B). For many clothing products, for example, there is a yarn forward rule similar to that used in EU agreements and similar in effect to that used by the US in the NAFTA and in proposed agreements with Singapore and Chile. For certain other products the rules in the Japan-Singapore agreement are different than those in EU and US agreements. With ROO differing by FTA the procedures for acquiring certificates of origin become more time consuming as the administrative costs increase. Multiple FTAs create a complex web of differing ROO. In 2004 a press statement from the AFTA Council stressed the importance of maintaining consistency with the CEPT ROO across all the FTAs being negotiated with Third Parties.

Given the current trend towards an increasing number of trade agreements in the region and the prospect of the implementation of a series of AFTA+ agreements for the ASEAN countries, including an agreement with China, a set of principles are suggested with regard to the rules of origin in such agreements—how the choice of rules of origin could affect the attainment of objectives specified by ASEAN relating to the promotion of regional production networks, the support for the development of small and medium sized enterprises, and the development of the lower income member countries:

- The rules of origin should be designed to have a neutral or minimal impact on trade flows whilst preventing trade deflection. Rules of origin are not an efficient or transparent means of supporting the production of intermediate products within the area or reducing the effectiveness of competition in final products. Simple, consistent and predictable rules of origin are more likely to foster the growth of cross-country production networks in the region. Different rules for the same product in different agreements are likely to hamper such a development.

- In general rules of origin which vary across products and agreements add considerably to the complexity and costs of participating in and administering trade agreements. The burden of such costs fall particularly heavily upon small and medium sized firms and upon firms in low income countries. Complex rules of origin, such as those applied by the US and the EU on clothing products, will tend to discriminate against small low income countries where the possibilities for local sourcing are more limited.

- Restrictive rules of origin targeted at sensitive products are not an effective mechanism for dealing with the adjustment difficulties faced by particular sectors. Longer transition periods to duty elimination (but with a firm commitment to implement) and suitably designed and implemented safeguard measures are more transparent and efficient.

- The complexity of the system of rules of origin is important in relation to the issue of trade facilitation. Customs clearance in most of East Asia is still slower than in Europe and North America. There is a risk that proliferating free trade agreements with differing rules of origin will further complicate customs procedures and compromise progress on trade facilitation in the region.

- The trend towards an increasing number of bilateral agreements centered on the ASEAN countries makes consideration of cumulation mechanisms an important issue. In Europe, the EU has sought to overcome the difficulties associated with the previous hub and spoke system[8] of free trade agreements by allowing for widespread diagonal cumulation amongst all of the EFTA, Central and Eastern European countries, and countries in the Balkans. Moreover, the agreements which comprise the Pan-European area of cumulation tend to have the same rules of origin based upon the Single List of the EU.

- Common rules of origin in East Asia would also facilitate the spread of full cumulation to new agreements, which again would be an important factor allowing for the development of regional production networks. Full cumulation provides for deeper integration and allows for more advanced countries to outsource labor-intensive production stages to low-wage partners. Full cumulation with simple rules of origin will make it easier for regionally based firms to exploit economies of scale that are available. Such cumulation would also allow low income countries the greatest flexibility in sourcing inputs.

- Even with cumulation, in certain cases the current 40 percent value-added rule may be difficult to comply with in certain sectors and particularly in low wage low income members. Greater flexibility in the AFTA rules of origin would be introduced if change of tariff heading were also available to producers in low income countries to confer origin as an alternative to the value added rule.

[8] Under the hub and spoke system activity tends to become focused on the hub (in this case the EU) with the principal trade being between the hub and the spokes and very little trade between the spokes. Cumulation can mitigate such an outcome.

- A coordinated approach to rules of origin given the proliferating number of bilateral free trade agreements in East Asia may be useful in avoiding a highly complex and extremely difficult to administer system of rules of origin in the region. The provision of clear and consistent rules of origin, with minimal costs to firms in adhering to them, will be fundamental to improvements in market access and the facilitation of trade in the region.

The following specific recommendations could be made:

- The current AFTA rule of origin is simple and transparent and its continued use, in conjunction with the program to clarify and improve issues of implementation, would provide a firm base for increasing economic integration of the ASEAN area. Customs cooperation between partners is an essential element of effective implementation of rules of origin.
- Allowing for alternative ways of proving origin is likely to be helpful to small and medium sized enterprises and to firms in low income members who do not possess the resources, such as sophisticated accounting systems, which are required under the value-added rule.
- Extending these AFTA rules of origin into new ASEAN+ agreements would maintain simplicity and hence would not compromise trade facilitation objectives. Such simple rules of origin with full cumulation would help to foster integration and the spread of regional production networks based upon freedom of sourcing of inputs throughout the whole trade area.
- In new bilateral agreements between ASEAN members and partners in say Europe and North America the approach to cumulation will have a crucial bearing on the extent to which these new agreements complement or compromise ASEAN integration. New bilateral agreements with full cumulation amongst ASEAN partners would help to ensure complementarity and that intra-ASEAN trade is not undermined.

7 The Way Forward

The original (and still current) ROO under the AFTA are simple and uniform. They have the key benefit of reducing lobbying for product specific ROO. However, standard ROO do not have an equal impact on either countries or industrial sectors—identical ROO can affect countries very differently depending on their level of development and export structures. The cost of complying with ROO is influenced by the administrative requirements and is generally higher for value added rules that are subject to fluctuation as the price of imports from third countries change over time either through exogenous price movements or adjustments in the exchange rate. When the tariff preference is less than 5 percent it is common for exporters to choose to export under MFN rather than incur the compliance cost of the ROO. The low utilization rate for the AFTA can be explained by the minimal margin of preference—below 2 percent—in the sectors that account for virtually all the existing intra-ASEAN trade.

Following the accession of the CLMV countries to ASEAN concerns were raised over the value added ROO. This resulted in a decision to reopen the debate on the appropriate ROO for the priority sectors and inevitably paved the way for negotiations on product specific ROO. ASEAN and individual Members are engaged in bilateral negotiations with third countries to conclude FTAs. In many of these negotiations ASEAN and ASEAN members will be requested to accept product specific ROO. This is the case with the US-Singapore FTA and the Agreements with Australia. It is not realistic, given the imbalance in economic size for ASEAN members to fundamentally change the basis of these ROO.

ASEAN members are under pressure from their current negotiating partners to move away from the exclusive dependence on the value added criteria and to move to Change of Tariff Classification. However, since the Harmonized System was not designed with the ROO in mind it will be necessary to supplement the CTC with a simple process requirement in a number of products. The key criteria for the ROO should be to authenticate that 'sufficient' processing took place within the RTA. ASEAN and ASEAN members should identify 'best practice' architecture for ROO that openly defines specific activities that are deemed insufficient and then aim to standardize this across all their FTAs. Such activities may include minimal processes such as enhancing the packaging, preparing goods for shipment, dilution, blending and other types of mixing, sorting, grading, marking, dismantling and repairs.

The 'best practice' architecture should also include introducing *de minimis*, ensuring light administrative requirements, and seeking diagonal cumulation across all ASEAN countries in all their FTA Agreements. As a priority ASEAN should authorize the private sector to issue the necessary Certificate of Origin Forms. Further, the ASEAN Secretariat could develop a Single Administrative Document across all the RTAs to which any of their Members is a Party.

Attention should also be given to ensuring as much as possible that the ROO are identical between the different agreements and that there is diagonal cumulation between all the countries involved in Free Trade Agreements to prevent the emergence of Hubs and Spokes and thus minimize the risk of trade suppression and trade diversion. The differences in approaches to ROO between the US and the EU and concerns by all the larger economies that China cannot use its FTA with ASEAN to indirectly secure preferential access through ASEAN to their markets render it unlikely that ASEAN will succeed in negotiating identical ROO across all their FTAs with external trading partners.

The incredible achievements of East Asia in becoming the factory of the world, and the production sharing networks that exist within the region, developed through firms being able to access their inputs at world prices. Maintaining and expanding the manufacturing base is dependent on firms continuing to source from the most efficient sources in the world at world prices. ROO that restrict or distort incentives on the sourcing of inputs will constrain future growth.

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Annex A

Method of Calculation of Local/ASEAN Content

1. Member Countries shall adhere to only one method of calculating local/ASEAN content, i.e., whether it is the direct or indirect method, although Member Countries shall not be prevented from changing their method, if deemed necessary. Any change in the calculation method shall be notified to the AFTA Council Meeting.

2. FOB price be calculated as follows:

    a. FOB Price = Ex-Factory Price + Other Costs
    b.Other Costs in the calculation of the FOB price shall refer to the costs incurred in placing the goods in the ship for export, including but not limited to, domestic transport costs, storage and warehousing, port handling, brokerage fees, service charges etc.

3. Formula for ex-factory price:

    a. Ex-Factory Price = Production Cost + Profit
    b. Formula for production cost,
        i. Production Cost = Cost of Raw Materials + Labor Cost + Overhead Cost
        ii. Raw Materials shall consist of: cost of raw materials, freight and insurance
        iii. Labor Cost shall include wages, remuneration and other employee benefits associated with the manufacturing process
        iv. Overhead costs shall include, but is not limited to, real property iterms associated with the production process (insurance, factory rent and leasing, depreciation on building, repair and maintenance, taxes, interests on mortgage), leasing of and interest payments for plant and equipment, factory security, insurance, utilities, research, development design and engineering, dies, moulds tooling and the depreciation, maintenance and repair of plant and equipment, royalties or license, inspection and testing of materials and the goods, storage and handling, disposable of recyclable wastes, port and clearance charges and any import duties paid.

Annex B: Rules of Origin in Existing Free Trade and Preferential Trade Agreements

	Change of Tariff Classification (HS digits, principal, secondary level)	Value Added		Specific Manufacturing Process	Cumulation	Tolerance	Absorption
		Domestic or Import Content	Implied Import Content				
A. Agreements Involving the EU							
EU – PanEuro	Yes (4,2)	Yes - Import (50-30%)	50-30%	Yes	Bilateral Diagonal	Yes 10%[b]	Yes
EU – GSP	Yes (4,2)	Yes - Import (50-30%)	50-30%	Yes	Bilateral Diagonal[a]	Yes 10%[b]	Yes
EU – Cotonou	Yes (4,2)	Yes - Import (50-30%)	50-30%	Yes	Full	Yes 15%[b]	Yes
EU – Chile	Yes (4,2)	Yes - Import (50-30%)	50-30%	Yes	Bilateral	Yes 10%	Yes
EU – Mexico	Yes (4,2)	Yes - Import (50-30%)	50-30%	Yes	Bilateral	Yes 10%	Yes
EU – South Africa	Yes (4,2)	Yes - Import (50-30%)	50-30%	Yes	Bilateral Diagonal (ACP) Full (SACU)	Yes 15%	Yes
B. Agreements in the Americas and with US							
NAFTA	Yes (2,4,6)	Yes – Domestic (60-50%)	50-40%	Yes	Bilateral	Yes 7%[b]	Yes[e]
Canada – Chile	Yes	Yes – Domestic (35-25%)	75-65%	Yes	Bilateral	Yes 9%	Yes
US-Israel		Yes – Domestic (35%)	65%		Bilateral[c]	Not App	Yes
C. Agreements In Asia/Pacific and with Asian countries							
AFTA		Yes – Import (60%)[d]	60%		Diagonal	Not App	
ANCZERTA		Yes – Domestic (50%)[d]	50%		Full	Not App	
Singapore - Japan	Yes (4,)	Yes – Domestic (60%)	40%	Yes	Bilateral	Yes	No
Singapore - New Zealand (ANZSCEP)		Yes - Domestic (40%)[d]	60%		Bilateral	Not App	
Singapore – US	Yes (2,4,6)	Yes – Domestic (55-35%)	65-45%	Yes	Bilateral	Yes 10%[b]	No

a Within Andean, ASEAN, CACM, SAARC only and subject to 50 percent value added requirement in export country.
b alternative rules for textiles and apparel products, often in terms of weight rather than value
c up to a maximum of 15 percent of the value of the product
d with the additional requirement that the last stage of manufacture be performed in the exporting country
e excluding automotive products
Source: WTO (2002) and trade agreements

Chapter 2
Rules of Origin and the Web of East Asian FTAs

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1 Introduction

The maze of East Asian regional and bilateral free trade agreements (FTAs) that has emerged in the last few years triggered fears of what the attendant rules and administrative procedures would imply for the cost of doing business in the region. If these agreements are mutually consistent, particularly with regards to rules of origin (ROO), the marginal costs of a new agreement will be minimal for all parties. The lack of coordination in rule-setting among countries, however, ensures that each trade route marked by preferential treatment will be differentially governed, thus leading to mounting information and transaction costs. Moreover, the specter of multiple and overlapping agreements among countries will only further increase the need to regulate trade so that preferences do not spillover unintendedly to non-partners via the member with the lowest trade barriers.

In a sea of preferential agreements, ROO are, in fact, seen as indispensable since they define the conditions that a product must satisfy to be deemed as originating from the country seeking preferential access. They are principally meant to prevent trade deflection, whereby products from non-participating countries destined for the partner country's market are redirected through free trade partners of the partner country to avoid the payment of partner country's customs duties. However, the intricacies brought about by ROO often work to hinder the flow of goods in the region and introduces new uncertainties in the conduct of trade.

The complexities surrounding the rules of origin could be traced from two sources. The first is the difficulty of ascertaining origin in an age of globalized trade and at the same time, increasingly fragmented production processes. When goods are produced in a single production stage then the origin of the products should be relatively easy to establish. Proof that the product was produced in the free trade partner should be sufficient. For other cases, ROO are used to define the methods by which it can be ascertained that the product has undergone sufficient working or processing in the free trade partner to qualify for preferential access. However, technological progress and globalization have made possible the further refinement of division of labor among various producers, in order to exploit scale economies and cost differentials among various countries. Consequently, the production of a single product often encompasses multiple locations, compounding the difficulties of verifying its origin.

The other reason behind the complex design of many ROO is the convenience in which these rules could be used to both accommodate and conceal protectionist intents. ROO, by increasing the local content of the product, or by attaching multiple criteria for the satisfaction of origin, could be another avenue to effectively exclude product groups from a country's liberalization commitments. Rules can also be made product-specific, so that the extent of protection is hidden in the hundreds of pages of annexes, and coated by technical language not immediately accessible to non-specialists.

The motives underpinning the creation of FTAs have a direct bearing on the design and degree of restrictiveness of ROO. For FTAs which are created largely for political and foreign policy purposes, cumbersome ROO provide effective means of shielding Members from the economic effects brought about by the removal of tariff barriers. If, on the other hand, the goal of regional

import substitution dominates, then ROO can make the conferment of origin conditional on a set of minimum regional content targets, which can spur trade diversion, especially in the use of intermediate manufacturing inputs. The FDI-motive, which is present in some FTAs, can exert two opposing pressures. On the one hand, it may lead to more restrictive ROO, as a means to entice rules-evasion on the part of non-partner investors. On the other hand, countries may actually intend to use an FTA to bring down the costs of transactions among members, so as to create a bigger market and a more attractive production base for foreign firms. In this case, the heavy requirements set by ROO become a genuine hindrance to the achievement of regional goals.

With the proliferation of FTAs observed especially in the last 3-4 years in East Asia, it becomes ever more important to take stock of the implication of these simultaneous agreements on the integration of regional markets. This chapter provides an overview of the preferential rules of origin in East Asia, highlighting the aspects that might possibly generate some trade-chilling effects; reviews some characteristics of rules of origin with special emphasis on lessons from the European experience; analyzes the important features of the existing preferential rules of origin in East and South-East Asia; and estimates the effectiveness of AFTA's preferential agreement and the costs of requesting preferences.

2 Lessons from Existing Preferential Trade Agreements

Origin determination. There are three main approaches to determining origin: (i) change of tariff heading, where the final product has to have a different tariff heading than the inputs used; (ii) value-added criteria, which define a minimum value-added to be done on the inputs in order for the final product to become originating; (iii) specific manufacturing process, which can be required in the production of the good to be eligible for preferences.

Several agreements require satisfying a combination of two or more methods (for example, not only a change of tariff heading has to be satisfied but also further specific manufacturing processes have to be completed in order to obtain the originating status). A basic change of tariff heading rule for cotton shirts can be satisfied if a country which imports woven cotton fabric (HS 5208) to produce cotton shirts (6105). However, the EU ROO replace the change of tariff classification with a requirement that the product has been manufactured from yarn. In effect this imposes the requirement that two stages of production must be undertaken in the partner or qualifying area to confer origin—not only the sewing of the fabric but also the production of the fabric itself. Clothing products made in FTA partners of the EU but which are made-up of fabrics imported from third countries, such as China, will not satisfy the EU origin rules and will not qualify for tariff reduction. As origin determination rules become technical they offer scope for the participation of industries in setting restrictive rules of origin (Hoekman, 1993).

As part of its reform process initiated in 2003, the EU is planning to replace the current the PANEURO ROO with a single value-added method which is expected to be clearer and more development-friendly (only 13% of tariff lines currently rely on the value-added criteria).

The burden of satisfying the restrictive origin requirements can be alleviated by allowing alternative means to satisfy the rules, thus providing certain flexibility for producers. For example, allowing producers to choose between a value-added criterion and a change of tariff heading, could provide greater flexibility for the traders and would allow them to choose the method which can be satisfied at the least possible cost.

When the origin requirements are too restrictive, satisfying the rules of origin may require a high degree of sophistication on the part of the firms to carefully track and show the origin and movement throughout the company of imported intermediate inputs.

A modern and efficient customs service is a necessary precondition for the proper implementation of complex rules of origin. Countries contemplating free trade agreements should carefully take into account the possible implications of rules of origins for the viability and success of any initiative. A web of free trade agreements in Asia (or any region) with complex and restrictive rules of origin may, in practice, have little impact on trade flows in final products and instead bring about a shift in the production and trade pattern of intermediate products, with possible adverse efficiency consequences for resource allocation. Origin determination should have a neutral impact on trade after achieving their basic objective of avoiding trade deflection.

Cumulation: With cumulation, inputs from preferential trading partners can be used in the production of a final good without undermining the origin of the product. Preferential and free trade agreements can have three different types of cumulation: bilateral, diagonal and full cumulation. Bilateral cumulation in NAFTA, for example, implies that originating inputs (that is, materials that have been produced in accordance with the relevant rules of origin) imported from another NAFTA member qualify as originating materials.

Of greater relevance is diagonal cumulation on a regional basis which allows qualifying materials from anywhere in the region to be used without undermining preferential access. In other words, parts and materials from anywhere in the region that qualify as originating could be used in the manufacture of a final product which could then be exported at the preferential rate within the region. The Pan-European agreement allows diagonal cumulation between member countries.

Finally, full cumulation allows any processing activities carried out in any participating country to be counted as qualifying content regardless of whether the processing is sufficient to confer originating status to the materials themselves. Full cumulation is applied, for example, in the EU's Cotonou agreement and in AFTA. Full cumulation could facilitate more fragmentation of production processes among the members of the free trade area and so stimulate increased economic linkages and trade within the region.

Full vs. diagonal cumulation. There is a risk that under full cumulation more developed countries can outsource labor-intensive low-tech production stages to less developed partners and lock them into these stages, therefore 'blocking' a more wide-ranging process of development. Diagonal cumulation, however, will stimulate more capital-intensive production processes and investments by requiring more stages of production/higher value-added to be undertaken in the country to fulfill the requirements of rules of origin and obtain preferences. The experience of developing countries under the EU's GSP scheme shows, however, that requiring high levels of value-added or multiple processing stages leads to lower uptakes of preferences and a lower level of all activities in the country.

Tolerance or De Minimis rule. These rules allow a specified percentage of non-originating products to be used in the production process without affecting the origin status of the final product. All EU preferential and free trade agreements contain de minimis rules. The percentage allowed in most of the EU agreements is 10 percent (exceptions are the Cotonou Agreement and the agreement with South Africa which allow 15 percent). The tolerance rule under the NAFTA allows non-originating inputs to be used even if the rule on sufficient processing is not satisfied, provided that their value does not exceed 7 percent.

Although the tolerance rule in principle lessens the burden of rules of origin for products with non-originating inputs, the tolerance rules applied to the textiles and clothing sector are often different and less favorable than the general rules of tolerance (Brenton, 2003). Nevertheless, tolerance rules can reduce the often too stringent requirements imposed by the value-added or change of heading requirement. They lessen the additional production costs which would otherwise have to be borne and permit more producers to meet the rules of origin requirements.

Duty Drawback. When non-originating materials are used in the production of a final product geared for exports, duty drawback provisions provide a waiving or a repayment of duties applicable to the non-originating material used. However, most preferential agreements do not allow duty drawback thus discouraging the use of third country inputs in the production processes. Some EU FTAs (for example the Cotonou Agreement and the GSP scheme) do not prohibit the usage of duty drawback provisions.

Allowing for duty drawback can reduce the magnitude of trade diversion in forming regional trade agreements. The use of duty drawback can be especially important for countries with intensive trading and production links with manufacturing networks outside the area of the preferential trade agreement. In these cases, eliminating the duty drawback when a preferential agreement is concluded would imply higher production costs for final-good assembly for exports or intermediate processing to partner countries in the PTA.

Outward Processing. Some preferential and free trade agreements allow for outward processing schemes. These schemes encourage processing overseas by providing relief from import duties on the compensating value of imports (the part that was previously exported for processing) after processing abroad. The amount of duty payable is calculated from the value of the product imported multiplied by the appropriate tariff for that product minus the hypothetical duty that would have been paid on the intermediate products exported under the processing scheme. For example, a firm which exports textiles under an outward processing scheme and subsequently re-imports clothing products would have to pay the (preferential or other applicable) duty on the clothing product but would be refunded the duty that would be applicable to the value of the textile products exported.

Within outward processing in textiles and clothing the EU has provided for a specific scheme known as "economic outward processing" where, often up to specific limits and/or subject to surveillance, imports after processing enter the EU duty free. Under this regime, goods temporarily exported from the EU for processing must be in free circulation within the EU and must have EU origin. If products of EU origin are insufficient, derogation can be granted from these rules, but for no more than 14% of the total value of the goods for which prior authorization is requested. There are further requirements in the regulation to protect the industry in the EU, such as commitments to maintain production and employment in the EU and maximum processing rules. The latter are the converse of the rules of origin in free trade and preferential trade agreements, which stipulate minimum processing requirements.

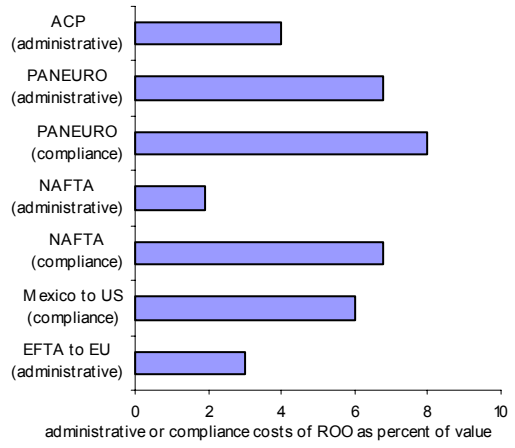
Allowing outward processing in preferential and free trade agreements could ease rules of origin requirements and reduce the administrative costs for outward processing linkages. The EU example suggests that documentation requirements for outward processing scheme are less costly than those for rules of origin (see Brenton and Manchin, 2003). Furthermore, outward processing could encourage greater production fragmentation which can be crucial for firms competitiveness.

Documentation of rules of origin. Administrative costs can vary with different documentation and certification methods. The EU requires a two-step private and public certification of rules of

origin, while NAFTA and other US preferential trade agreements require a single-step private certification which does not have to be repeated each time. Cadot et al (2005) estimate that the administrative costs of the Pan-European preference scheme is around 6.8% while the administrative costs under NAFTA are around 1.9%. The large difference in the administrative costs between the two regimes is mainly attributable to the different certification methods used in the two schemes. The self-certification used in NAFTA is less burdensome for traders. Authorities should be careful in designing the certification process of rules of origin as it can significantly increase the costs of requesting preferences and thus reduce the potential positive impact of trade integration.

Costs of proving and satisfying origin. Given the complexities of ROO, *satisfying* origin requirements involves important costs. Actually *proving* origin compounds these costs. Several studies have estimated the costs of obtaining preferences and found them to be substantial (Figure 1). The benefits offered by preferential trade agreements are decreasing and could become marginal if the costs of obtaining these preferences remain high.

Figure 1: ROO are not cheap!



Note: EFTA-EU (Herin, 1986); Mexico-US, 2001 (Carrière and de Melo, 2004); NAFTA and PANEURO, trade weighted (Cadot et al., 2005); Cotonou for non-least developed ACP (Manchin, 2006).

The costs of proving origin involve: (i) satisfying the administrative procedures required to provide the necessary documentation; (ii) maintaining systems that accurately account for imported inputs from different sources to prove consistency with the technical rules. The ability to prove origin may require the use of sophisticated and expensive accounting procedures (by the standards of small companies in developing and transition economies). Without such procedures it is difficult for companies to show precisely the geographical breakdown of the inputs that they have used. The costs of proving origin may be even higher, and possibly prohibitive, in countries where customs mechanisms are poorly developed. Even if producers can satisfy the rules of origin, in terms of meeting the technical requirements, they may not receive preferential access to the EU because the customs authorities do not accept their proof of origin or because the costs of proving origin are high relative to the duty reduction that is available.

The economic impact of preferential tariff reduction may be discontinuous—initial reductions in tariffs could have little impact on trade since they will be less than the costs of proving origin; only once the gap between the preferential tariff and the MFN rate exceeds the costs of proving origin will there be a stimulus to trade.

The burden of production costs induced by restrictive rules of origin can be somewhat reduced by allowing less restrictive cumulation rules (such as diagonal or full cumulation), duty drawback, outsourcing, and higher de minimis levels. In an analysis on the implications of rules of origin for trade based on a sample including 155 countries, Estevadeordal and Suominen (2005) find that rules of origin regimes which allow duty drawback, outsourcing, less restrictive cumulation, and higher de minimis rules are more successful at fostering bilateral trade than those which do not.

Administrative costs can also be reduced by more trader 'friendly' approaches, such as using self-certification methods.

3 Rules of Origin in East and South-East Asia

i. Overview of the main rules of origin provisions in East Asian FTAs

ROO in Asian FTAs stand out for their generality. Asian FTAs—such as the ASEAN Free Trade Area (AFTA), Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA),[1] Singapore-Australia Free Trade Agreement (SAFTA), and the South Pacific Regional Trade and Economic Cooperation (SPARTECA) in the Asia-Pacific—have fairly simple or general ROO (Estevadeordal and Suominen, 2004). However, the new generation of Asian FTAs is increasingly introducing product-specificities in the design of ROO, such as the ASEAN-China FTA and the ASEAN-Korea FTA. Table 1 describes the main features of the rules of origin of FTAs in East Asia that have been signed or where full documentation is available.

AFTA ROO adjust. For many heavily-traded products in the region, like electronics, production processes may be so fragmented that the value of local content is often a small percentage of the product's total value. Very early on in the formation of AFTA, it was recognized that the 40% ASEAN origin rule may often not be met in the case of trade in textile and textile products. In 1995, it was therefore decided that either the percentage value-added or the substantial transformation rule may be used by ASEAN exporters. The AFTA ROO underwent further overhaul, starting in 2003, when operational procedures were further clarified and simplified. In the same year, the decision was reached to adopt a change in tariff heading rule for determining the origin of the product as a general alternative rule "applicable to all products which cannot comply with the 40% local/ASEAN content requirement, giving priority to sectors which are the subject of private sector requests and those sectors prioritized by the ASEAN Economic Ministers (AEM) for "accelerated integration" (AFTA Council, 2003).[2] As of 2005, the change of tariff heading rule is fully endorsed for four sectors: wheat-flour,[3] wood-based products, aluminum products and iron and steel.[4]

The ASEAN-China Free Trade Area (ACFTA) adopts the same general value-added rule of the AFTA of 40% local/regional content with full cumulation. The Agreement on Trade in Goods is currently in force, which extends the liberalization commitments from the limited 'Early-Harvest' agricultural products (HS chapter 01 – 08), to the rest of the traded sectors in the normal inclusion list. As in the AFTA ROO, an alternative change of tariff heading criteria can be invoked for a number of products. Negotiations are still on-going for the product specific rules of other sectors. Only the specific ROO are finalized in sectors under the normal inclusion list.[5]

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[1] CER (Closer Economic Relations), CEP (Closer Economic Partnership), SEP (Strategic Economic Partnership), are all names used interchangeably with FTA.

[2] In November 2004, 11 priority sectors were identified for deeper integration where tariffs will be eliminated in at least 85% of the products in 2007 for ASEAN-6, and 2012 for Cambodia, Laos, Myanmar and Vietnam. These sectors are: agro-based products, automotive products, electronics, fisheries, rubber-based products, textiles & apparels, wood-based products, e-ASEAN, health care, tourism and air travel. See http://www.aseansec.org/15070.htm for AFTA Council reports.

[3] For wheat-flour products, change of tariff heading is the sole origin criterion.

[4] Product-specific rules are negotiated only upon the request of private sector groups.

[5] In the case of ACFTA, the rule applies for 424 (HS6) textile and textile products items, 2 items of preserved fish, 6 items of wool, 22 of leather goods, 14 for fur skins and 4 item lines of footwear. It is only

The ROO under ASEAN-KOREA Free Trade Area (AKFTA) are even more liberal than AFTA's. AKFTA is the most recent agreement that has been concluded in the region (May 2006), although Thailand has not yet signed. The general 40% value-added local-regional content of AFTA and ACFTA is extended to this free trade area, as well as the full cumulation rule. AKFTA ROO emerge now as even more liberal than those of AFTA because the change of tariff heading, as an alternative rule to the 40% content requirement, is applicable to a greater number of products relative to the coverage in AFTA and ACFTA. *A novelty has also been introduced in AKTFA, namely, the back-to-back Certificate of Origin (CO), which allows the conferment of preferences to the re-exports of partner A into partner B of products first exported by partner C into A.*[6] *This is particularly advantageous for countries engaging in substantial entrepot trade such as Singapore.*

For Singapore FTAs, the degree of restrictiveness of the ROO largely reflects the sensitivities of Singapore's partners. In the ***Japan-Singapore EPA (JSEPA)***,[7] agricultural products and textiles and apparel are characterized by particularly complex rules. ROO are product specific, relying mostly on the change of tariff heading rule.[8] For some products an alternative regional value-added criterion (RVC) rule is allowed, albeit at a high rate of 60%. In cases where RVC is an additional criterion to be satisfied, the content requirement is lower at 40%. *De minimis* is permitted, also varying across products. Moreover, outward processing is recognized in all of Singapore's FTAs.

The ***Korea-Singapore FTA*** follows the same pattern of product specificity as JSEPA, with the change of tariff heading rule as the dominant origin criterion. For some products an additional RVC of 45%, 50% or 55% is required, and for a few items the RVC rule alone will suffice. The sensitivity of textiles is seen in the added details in the description of transformation rules, and in its exclusion from the 10% *de minimis* rule.

In contrast, a general value-added rule of 40% is applicable to all products under the ***Agreement of New Zealand – Singapore for Closer Economic Partnership (ANZSCEP).*** Both countries are parties to yet another FTA, the ***Trans-Pacific Strategic Economic Partnership Agreement (TRANSEP)***, which was formed in June 2005 together with Brunei and Chile.[9] Under this agreement, ROO contain product specific change of tariff heading rules, with some products having an additional RVC provisions ranging from 45% to 50%, as in the case of textiles and footwear. Still, for some products, the CTC and RVC are alternative rules. The agreement allows

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in 5 wool tariff items, that the change of tariff heading is set as the exclusive rule. See Annex 3, Attachment B of the ASEAN-China FTA Agreement (http://app.fta.gov.sg/data//fta/file/ACFTA_Annex3.pdf).

[6] Singapore imports, say, 10 units of televisions from Korea, where the preferential duties apply under the AKTFA. A back-to-back certificate allows Singapore to re-export, for instance, 7 of those units to ASEAN, and still be able to avail of the same preferential rates any ASEAN member would impose on Korean-made televisions.

[7] Japanese FTAs are incorporated in an 'Economic Partnership Agreement ' (EPA), which has a broader scope than the typical FTA, such as e-commerce, financial services, information and communication technology and Human Resource Development.

[8] Heading changes are needed for HS 01- 24, HS 38 (chemical products), HS 85 (machinery), while subheading or value content requirements for liquor and cordials apply. For the rest a RVC requirement of 60% with a combination of subheading changes is needed. The yarn-forward rule applies for textile fabrics and articles (HS 59).

[9] Trans-Pacific SEP was previously known as the Pacific Three Closer Economic Partnership (P3-CEP). Its negotiations were first launched at the 2002 APEC Leaders Summit by leaders of Chile, Singapore and New Zealand. Brunei first took part as a full negotiating party in the fifth round of talks in April 2005.

for a tolerance rule according to which origin can be conferred provided that the non-partner content does not exceed 10% of the goods' value. In effect, the product specific rules apply only to the trade between Chile and the rest of the TRANSEP countries, and between Brunei and New Zealand, since a general value-added rule applies for the other pairs of countries under the ANZSCEP agreement (for Singapore and New Zealand), and under AFTA (for Brunei and Singapore).

In the ***Australia's FTA with Singapore (SAFTA)*** ROO are less general than in the ANZSCEP since a value-added requirement of 30% is imposed for some products (110 HS8 tariff lines mostly in HS 84-85) while for the rest, a higher 50% local/regional content is required. For some 152 tariff lines an additional requirement is imposed that the last process in the manufacture of the product must take place within the territories of the party seeking the preference.

As opposed to the generality and the broad scope of the ROO in the Singapore-New Zealand FTA, the ***Thailand-New Zealand (THAINZCEP)*** and ***Thailand-Australia (TAFTA)*** **agreements** contain specific rules for all products**.** The CTC rule is once again predominant, with some products allowing a change in subheading. An additional RVC requirement of 50% for THAINZCEP and 55% for TAFTA is imposed mostly for textiles and textile materials. Clothing is further restricted by making origin conditional on the performance of essential processes, such as cutting and sewing. In the case of TAFTA, transformation from specific headings and subheadings is excluded for some products.

The ROO of the ***Australia – New Zealand CER (ANZCER)*** have undergone a major revision early in 2006 and took effect in January 2007.[10] The RVC rule of 50% previously applied to all products. In the revised ROO, the CTC/ change of tariff heading approach has been adopted, although the RVC rule of 45% is still the exclusive criterion for some textile sectors such as those in men's and boys' apparel.

The new bilateral agreements reached by Japan with individual ASEAN Members are intended to be incorporated (as annexes) in the ASEAN-Japan FTA (AJEPA), and will not be open to renegotiation once the negotiations for the ASEAN-Japan FTA are completed. The ***Japan-Malaysia Economic Partnership Agreement (JMEPA)*** is the first to be concluded under this foreseen trajectory towards an AJEPA. The ROO are, as in the JSEPA (with Singapore), largely based on the change of tariff heading rule, with a high degree of product specificity. Even the *de minimis* rule varies according to product categories. For some sectors the RVC rule (40% - 50%) is an alternative, while for others it is the sole criterion for conferring origin. *The novelty in the JMEPA is that for some products the change of tariff heading rule is only valid if the non-originating material is sourced from any of the ASEAN country. This is most likely done in anticipation of possible cumulation rules under the future AJEPA.*

[10] Under the agreement, exporters can still choose to use the old RVC rule till 2012.

Table 1: Rules of Origin in East Asian FTAs

	Change of Tariff Classification	Value Added Dom. or Import Content	Specific Manufacturing Process	Cumulation	Tolerance
ASEAN FTA (AFTA)	Yes[11]	Regional (40%)		diagonal	
ASEAN-China (ACFTA)	Yes	Regional (40%)		diagonal	
ASEAN-Korea (AKFTA)	Yes	Regional (40%)		diagonal	
Singapore – Japan (JSEPA)	Yes	Dom. (60%)	Yes	Bilateral	product specific
Singapore - New Zealand (ANZSCEP)		Dom. (40%)		Bilateral	10
Singapore – Australia (SAFTA)		Dom. 50% (30% for some products)			3%
Singapore-Korea (KSFTA)	Yes	45-55%		Bilateral	10%[12]
Thailand-Australia (TAFTA)	Yes	40-45%	Yes	Bilateral	10%
Thailand- NZ TNZCEP	Yes, product spec.		Yes	Bilateral	10%
Malaysia-Japan (JMEPA)	Yes, product spec.	Dom. 40% (product specific)		Bilateral	Only from ASEAN (product specific)
Trans-Pacific TRANSEP[13]	Yes	45-50%	Yes	Diagonal	10%
Australia – NZ (ANZCERTA)		50%		Bilateral	

Source: WTO (2002) and trade agreements

ii. Problems surrounding the use and implementation of ROO

AFTA preference utilization rates are low by FTA standards. The test of the efficacy of a FTA in inducing intra-bloc trade is the extent in which preferences are taken up by the business sector. There is no systematic reporting of intra-ASEAN imports that were given origin certifications (i.e. imports accompanied by Form D).[14] According to the Bureau of Economic Integration of the ASEAN Secretariat, there is not one single year since the CEPT Scheme began in 1993, where Form D data is available for all 6 original AFTA countries.[15] Estimates of preference utilization rates based on firm interviews conducted for the ASEAN Secretariat show a utilization rate of about 5% of total trade. Although preference under-utilization is not unique to ASEAN, this estimate is certainly low relative to the known records of other preferential schemes. For

[11] Applicable for textiles and wood-based products, iron & steel as an alternative rule, and for wheat & flour as an exclusive rule.
[12] For yarns and fibers used for clothing and textiles products 8% applies; the de minimis rule does not apply to agricultural products or applies with restrictions.
[13] Strategic Economic Partnership (SEP); members: Brunei, New Zealand, Chile and Singapore.
[14] The total amount of intra-ASEAN imports seeking preferential rates under the CEPT Scheme can be extracted from the Form D certificates.
[15] Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand.

example, about 35% of eligible exports from the CEEC countries enter the EU using the available preferential rates (Brenton and Manchin, 2003).

One reason for the low utilization of preferences for AFTA and ANZCERTA that rely on the RVC rule may be traced to the inability of exporters to cumulate the necessary local/regional content, especially given the degree of process fragmentation in East Asia. East Asia is at the forefront of global production networks—whereby the production process is fragmented across several countries. Half of East Asia's trade is in electronics and machinery, where production networks are widespread. The import content of electronics and machineries is highest for ASEAN (Table 2). The share of imports is particularly high in these sectors for Singapore and the Philippines. The figures reported here are most likely understated since the data do not differentiate between output destined for local consumption and output for exports—the import content for exports is usually higher than for products sold in the local market because of various fiscal incentives (i.e., import duty drawbacks) available for export production in most countries.

Table 2: **Import content of selected sectors in East Asia, 2001**

	Textiles	Clothing	Leather	Chemicals	Motor vehicles	Transport equipment	Electrical machinery	Machinery equipment	Other manufacturing
Indonesia	27.42	6.56	8.44	29.33	25.12	40.09	23.09	56.88	9.37
Malaysia	38.04	39.24	73.23	27.36	35.95	29.53	44.08	34.10	39.92
Philippines	37.80	40.71	26.72	38.67	44.94	23.72	70.23	56.62	18.67
Singapore	51.15	44.35	34.56	42.19	41.75	36.17	83.19	58.24	46.29
Thailand	23.26	12.95	26.08	22.72	38.07	63.94	57.22	48.86	27.60
ASEAN	35.53	28.76	33.81	32.05	37.16	38.69	55.56	50.94	28.37
Rest of ASEAN	23.26	12.95	26.08	22.72	38.07	63.94	57.22	48.86	27.60
China	11.00	10.60	8.33	12.84	12.69	11.50	35.65	13.46	8.63
Japan	10.17	6.95	11.10	8.44	1.67	5.11	8.23	5.29	6.12
Korea	19.31	16.02	35.11	19.51	10.13	18.26	36.50	17.81	15.48
Australia	14.15	29.72	22.08	17.98	24.02	24.91	32.46	20.25	13.01
New Zealand	14.15	29.72	22.08	17.98	24.02	24.91	32.46	20.25	13.01

Source: Authors' calculations based on GTAP6 database (2001 is latest available year)

Another reason for the under-utilization of preferences is the complexity of administering and complying with the ROO. LDC exporters are particularly burdened by high compliance cost, not to mention the more fundamental difficulty of local sourcing to meet whatever RVC requirements are imposed. The use of general rules such as the value-added content rule across all products in many East Asian FTAs (such as AFTA and ANZCER) is clearly more desirable in terms of transparency and clarity relative to product-specific rules. But there are many difficulties in complying with this rule:

- Computation of costs, invoicing, and other documentation demands inherent in the RVC rule are complex, especially for smaller firms or firms from less developed East Asian countries.
- Customs valuations differ across countries. While continued efforts are being made to address the problem, it will take considerable time before the decision to harmonize, undertaken at the highest policy level, is translated into daily practice in all trading ports.[16]

[16] In AFTA, the different tariff classifications adopted by members is a particular problem. This was addressed in 2004, when a common ASEAN tariff nomenclature (ASEAN Harmonized Tariff

- AFTA requires pre-export inspections, usually performed by the local trade ministries. Exporters are usually expected to submit a cost analysis of the product with accompanying invoices and documentation. The actual certificate (i.e. Form D in AFTA's case) needed to request preferences will then be issued by the Trade Ministry upon verification of the product costs.[17]
- Transactions remain very time-intensive, as face-to-face contact with various ministry and customs officials is still the norm rather than the exception.
- Incoming goods that enjoy preferences are randomly subjected to post-audit checks. In theory, coursing products in ASEAN through the "green lane"[18] provide traders in AFTA goods substantial benefits in the form of expeditious release of cargo and overall lower administration costs. In practice, however, some traders avoid the green lane on purpose because products entering through this window are more likely to be subjected to extensive post-audit checks.[19] The so-called "red lane" with ordinary clearance examinations is preferred instead. This is an example of a trade-facilitating device, such as the post-audit system, turning into a source of uncertainty that hinders trade.
- In the absence of automation, clear, harmonized rules and readily accessible conciliation or objection procedures, the actual valuation of costs heavily depends on the judgment of individual customs officials. This is even more so in an environment where contesting the rulings would imply more costly delays without any certainty of neutral arbitration.

What can be done? In order to ease delays and costs involved in proving compliance with ROO, *self-certification* is one solution that can be introduced. This was in fact proposed by Australia, Korea, China, and Japan in their respective FTA negotiations with ASEAN. However, the notion of self-certification is not very common in the culture of customs inspection in ASEAN.

In order to ease the potentially cumbersome procedures involved in the valuation and certification of declared costs under the RVC rule, ASEAN members have decided to follow the example of ANZCER in *shifting to the CTC* criteria for all products. The ASEAN-Korea FTA (AKFTA) is now more flexible than AFTA since the change of tariff heading alternative is available for all products. For products where the preferential tariffs under AKFTA approximate the levels found in AFTA, preferences in AFTA will be eroded by the more liberal rules offered by the AKFTA.

The trend towards product specific rules is not without risks. What may begin as a facilitating measure may eventually be used to introduce protectionist restrictions. This can be done by excluding inputs from certain tariff headings, attaching an essential process in the transformation of the product, or turning to the RVC as an additional instead of an alternative rule to satisfy

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Nomenclature, or AHTN) came into force. Another project is the ASEAN Single Window which involves the computerization of clearance procedures with common formats fulfilling the requirements of the international rules of WCO (World Customs Organization) and WTO. The project is currently still being pilot tested between Malaysia and the Philippines.

[17] Pre-export inspections are meant to check the conformity of the product with the rules of origin. It must also be verified whether statements in the Certificate of Origin correspond to the supporting documentary evidence submitted. Finally the descriptions, quantity and weight of goods, marks and number of packages, as specified must be seen to be conforming to the products to be exported.

[18] The 'Green Lane' system allows the importation of ASEAN-origin products without extensive examination.

[19] Based on interviews done by the Japan External Trade Organization (JETRO) of Japanese firms active in the region (JETRO, 2004).

origin. Bilateral FTAs with restrictive product specific rules will also most likely define the parameters of wider FTAs formed later on, as in the case of the Japan-ASEAN EPA.

For FTAs such as AFTA which group countries with a wide variation in MFN tariff levels, avoiding trade deflection will always be a difficult challenge given the complexities of verifying the origin of goods produced or assembled from multiple locations worldwide. The burden of proper verification becomes all the more taxing in an environment where the proliferation of bilateral FTAs leads to numerous potential 'backdoors' that need effective policing. The likelihood of trade deflection increases when relatively high tariff countries like Thailand or the Philippines also acquire access to pockets of low barriers. This in turn might lead to more intensive or heavy-handed verification procedures that will further hike administrative and waiting costs. If implementation indeed becomes too difficult, leading to the inability to arrest a significant amount of trade deflection, it may have a direct adverse consequence on the level of domestic political support for the FTA.

The lack of coordination in setting ROO amidst the proliferation of FTAs has a political cost attached to it, namely the cost of choosing favorites among favorites. Different permutations in the exchange of concessions among countries result in ROO with varying degrees of restrictiveness, which in turn lead to a hierarchy of partners not unlike the EU's so-called pyramid of preferences. Differentiating partners into friends, lesser friends, and foes has bred all sorts of animosities, and has not created an environment conducive to the development of closer or strategic economic partnership. The recent surge of FTAs in East Asia may be less about trade and more about issues like trade facilitation or regulatory barriers involving investments and services, where negotiations have bogged down in the multilateral arena. It is not unlikely that irritations stemming from contentious ROO negotiations, or the uneven restrictions applied to trade among different partners, could spillover to more important, high-stake negotiation areas.

4 The Importance of Preferences in AFTA

Using a gravity model to estimate the impact of preferences on trade flows in five ASEAN countries,[20] the preference margin has a negative significant effect on trade when the difference between third country tariffs and preferential tariffs are lower than 5 percent. This might be because of the costs of requesting the preferences—such as administrative costs, and the costs of complying with the rules of origin requirement of the preferences—are higher than the benefits from obtaining preferential treatment. When the difference between preferential and MFN tariffs are between 5 and 10 per cent, the coefficient remains negative but becomes insignificant. While margins of 10 to 25 percentage points register a slightly positive effect, the coefficient is insignificant. Preferences start to have a trade stimulating effect only when preferential tariffs are at least 25 percentage points lower than the MFN rates (Figure 2).

These results suggest that the costs of requesting preferences within AFTA might be in the range of 10-25%. These costs—which typically include costs of documentation and administration of ROO—are somewhat larger than those of other preferential schemes (see Figure 1 above). For products with very high preference reduction, the impact of preferences is reversed and turns

[20] The four countries are Indonesia, Malaysia, Philippines, and Thailand (Singapore and Brunei have zero MFN tariffs, while the other ASEAN members are still implementing AFTA). The estimations are undertaken at the 6-digit HS level for 2001-03. They are not based on actual utilization rates but on normal intra-regional trade flows which do not take into account whether preferential tariffs were actually applied or not.

negative. One explanation for this could be the presence of NTMs that inhibits trade, the negligible supply of the product within the region, or redundancy due to other regional import substitution instruments in place. For products where traders can choose between satisfying the value-added requirement or an alternative rule requiring specific production processes to obtain originating status, trade is lower than normally expected.[21] These products include textiles and apparel, which are typically protected. Even with providing an alternative rule for origin determination the requirements for obtaining originating status for these products might still be too restrictive. Since ASEAN sources its textiles imports largely from outside the region such as China, US, EU and South Asia, this implies that the preferential margins given to textiles are insufficient to alter the competitive position of regional producers vis-à-vis their non-ASEAN counterparts.

Products with the highest margins of preference typically have a low value of import as a share of total intra-ASEAN trade (Figure 3). For Thai imports of women's/girls' silk blouses (HS 620610) from ASEAN, for instance, a preference margin of 60 percentage points is applicable, but out of the total imports of Thailand for this product, only 6% is sourced from ASEAN (Table 3). This propensity to extend high preferences on products where little or no intra-ASEAN trade takes place is sometimes called the 'snow-plough' effect (Menon, 2005), referring to the failed ASEAN Preferential Trading Arrangement where preferences were given mostly to trade-irrelevant products such as snow-ploughs.[22] In the AFTA agreement, vehicles especially designed for traveling in snow (HS 870310) are given a high preference margin.

Figure 2: Trade impact of preference margins

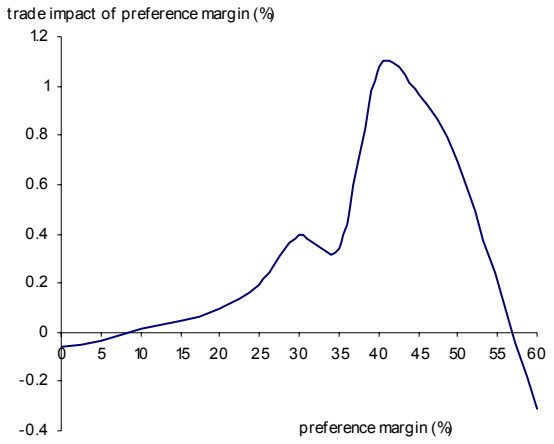
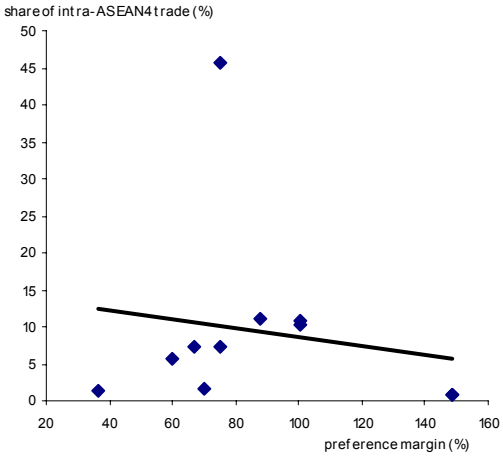


Figure 3: High preference margins given to products with little intra-regional trade



Source: authors' calculations

Countries that confer the highest margins also appear to be the ones that impose non-tariff measures on these same products. Indonesia, Malaysia, Philippines and Thailand, for instance, offer high margins for vehicles in the HS 870310 category, but all four countries likewise impose non-tariff measures on that product. Malaysia also imposed quantity control measures on vehicle products, some of which register the highest margins found in ASEAN (148%). While non-tariff measures are often justified, the coincidence of large tariff discounts and NTMs could reveal the

[21] A dummy variable included in the regression to capture this effect has a negative and significant coefficient.

[22] The ASEAN Preferential Trading Agreement (PTA) was instituted in 1977,

remaining areas of import substitution which are resistant to liberalization even if limited to AFTA countries.

The only high margin item with a large share in total intra-ASEAN imports is vehicle bodies (HS 870710), 97% of which consists of Malaysian imports from Thailand. In this case, imports are mainly driven by an industrial complementation scheme, wherein the buyer, source, and brand are pre-specified under the terms set by the said regional program.[23] In addition to tariff preferences, products included in this program also enjoy local-content accreditation and other non-tariff incentives. The large margins for vehicle bodies are therefore likely to be redundant; moreover, they do not originate from the importer (Malaysia) but from the principal exporter (Thailand). The substantial differential in preferences in this case therefore merely reflects Thailand's import substitution policy in this sector, as shown by the high MFN rates of 80%.

Over 90 percent of intra-ASEAN4 trade occurs in commodities where preference margins are below 25 percent—the threshold for using the preference (as seen above). Preferences do not have a significant effect on trade for the bulk of intra-ASEAN4 trade. Figure 4 maps the share of imports eligible under two ranges for preferential tariffs margins: more than 25% and more than 0% but less than 25%. Only about 8% of eligible trade flows fall into the category where preferences "are worth being used". Preference underutilization in ASEAN can be due to the nature of the regional production chains where non-ASEAN import content could be very high. A significant part of the manufacturing sector in ASEAN has been established through FDI by multinationals which bring in major components from parent companies outside the South-East Asian region. Although the rules of origin of AFTA requiring at least 40% cumulative regional content could be considered relatively liberal compared to some other regional agreements due to full cumulation and the relatively lower value-added required, electronics and electrical products—which make up about 40% of intra-ASEAN trade—typically have an ASEAN value-added component of only 8–15% (Dennis and Yusof, 2003). These products also have a low preference margin given that their MFN rate is low.

[23] The Brand-to-Brand Complementation Scheme was set in 1988 to encourage joint production in ASEAN. This was later phased out in 1995 and incorporated into a new ASEAN Industrial Cooperation (AICO) Scheme.

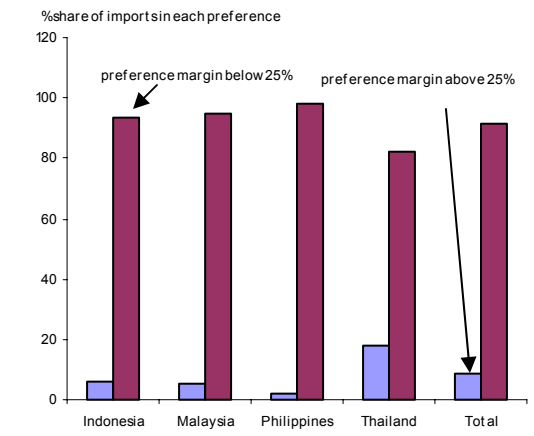
Table 3: Incidence of Non-tariff measures on products with high preferential margins (2003)

High margin products	HS6 code	Preference margin (%)				Share of intra-ASEAN trade (%)		NTM incidence
		IDN	MYS	THA	PHL	ASEAN4	ASEAN10	
Compound alcoholic preparations	330210	**87**	0	1		10.96	2.06	
women's/girls' silk blouses	620610	14	15	**60**		5.58	5.48	Thailand – import license
Vehicles specially designed for traveling on snow, golf cars & similar vehicles	870310	**70**	23			1.7	0.0	Indonesia – 6100, 8100 Malaysia – 6170
Vehicles w/ spark-ignition internal combustion reciprocating piston engine, of a cylinder capacity exceeding 1,500 cc but not exceeding 3 000 cm3	870323	37	**101**	65	25	10.74	10.7	Indonesia – 6100, 8100 Malaysia – 6100 Philippines – 6100 Thailand – 6170
Vehicles w/ spark-ignition internal combustion reciprocating piston engine, of a cylinder capacity exceeding 3,000 cc	870324	40	**149**	57		0.7	0.6	Indonesia – 6100, 8100 Malaysia – 6100 Philippines – 6100 Thailand – 6170
Vehicles w/ compression-ignition internal combustion piston engine (Diesel /semidiesel), of a cylinder capacity exceeding 1,500 cc but not exceeding 2 500 cm3	870332	**37**			25	1.4	1.4	Indonesia – 6100, 8100 Malaysia – 6100 Philippines – 6100 Thailand – 6170
Vehicles w/ compression-ignition internal combustion piston engine (Diesel /semidiesel), of a cylinder capacity exceeding 2,500 cc	870333	40	**148**		25	0.9	0.9	Indonesia – 6100, 8100 Malaysia – 6100 Philippines – 6100 Thailand – 6170
Components, parts, accessories for assembly of motor vehicles	870390	75	**101**			10.3	9.6	Indonesia – 6100, 8100 Malaysia – 6100 Philippines – 6100 Thailand – 6170
Bodies (incl. cabs), for the vehicles of hdg. 8703	870710		25	**75**		45.7	45.7	Malaysia – 6170
Bodies (incl. cabs), for the vehicles of hdg. 8701 to 8705, excl. 8703	870790			**75**		7.3	6.0	
Motorcycles w/ reciprocating internal combustion piston engine	870020	25	36	**67**	25	7.3	7.3	

Source: ASEAN Secretariat database of Non-Tariff Measures

Note: NTM codes: 6100 – non-automatic licensing (quantity control measure); 6170 – non-automatic licensing (discretionary import license); 8100 – Technical regulations.

Figure 4: share of preference margins below/ above 25%



Source: authors' calculations

5 Conclusion

The proliferation of preferential trade agreements in East Asia containing different rules of origin has important implications for economic integration in the region. The expansion of separate FTAs is likely to increase administrative costs for traders. If rules of origin are considerably different between agreements not only administrative costs but also production costs will be higher for firms. Costs caused by these differences are likely to be higher for small producers than for large producers operating in the hubs. The costs of operating in several preferential trade agreements might become so high that producers in the spoke countries might only be able to trade under one single preferential scheme. Extending the same cumulation and origin determination rules between FTAs could greatly reduce the costs for traders.

Lessons from EU experience indicate that there are a number of factors which could further lessen the negative effects of restrictive rules of origin schemes. The burden of production costs induced by restrictive rules of origin can be somewhat reduced by allowing less restrictive cumulation rules (such as diagonal or full cumulation), allowing duty drawback, outsourcing and higher de minimis levels. Furthermore, administrative costs can be reduced by more trader 'friendly' approaches, such as using self-certification methods.

Results from the empirical assessment of the potential impact of preferences on trade flows under AFTA and the costs of requesting preferences suggest that CEPT tariffs are typically exploited when the preference margins are higher than 10-25 percent. Such margins (above 25%) cover only 9.2% of tariff lines in Indonesia, Malaysia, Philippines and Thailand, and account for 7.8% of the aggregate value of their joint imports. Firm interviews have shown that the rough utilization rate of preferences is around 5% (of total import value).

Preference margins below 5%, and above 80% have a significant negative effect on trade flows—the former due to administrative and other costs related to obtaining preferences exceeding the benefits from preferences, and the latter due to the larger incidence of NTMs in these products. In order for future preference schemes in the region to deliver improved market access and regional integration a careful design of rules of origin aiming at less restrictive rules would be essential.

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Annex

The results presented above were the outcome of an empirical analysis, the objective of which was to explore the effects of preferences on trade flows and to provide an approximate estimate for the costs of requesting preferences under AFTA by concentrating the analysis on disaggregate trade flows which are eligible for preferences. Due to the non-availability of data which would distinguish between trade flows which obtained preferences and flows which did not, we carry out the analysis using normal trade flows. While the obtained estimates do not provide a precise quantification of the costs of preferences due to this data limitation, we nevertheless are able to obtain an estimate of the importance of preferences for trade flows and of the minimum level of preferences needed in order to have a positive trade stimulating effect on intra-AFTA trade flows.

Data availability constrains us to limit the analysis to the period of 2001 – 2003. The analysis is conducted at 6-digit HS level and includes Indonesia, Malaysia, Philippines and Thailand as reporting countries and the same four countries and Singapore as partner countries. The decision to focus on only four countries, is due to the fact that preferences no longer matter for Singapore and Brunei given the predominance of zero MFN tariffs. The new members, on the other hand, are yet to fully implement the CEPT scheme[24], and together account for a small share in intra-ASEAN trade. Thus we excluded those trade flows for which the third country tariffs were zero or equal to the preferential tariff. The data covers the period 2001-2003 which yields a database of 42,268 observations on bilateral trade flows.[25] Data on geographical variables were obtained from the Paris based Centre d'Etudes Prospectives et d'Informations Internationales (CEPII).

To measure the importance of trade preferences on intra-ASEAN trade flows we use a gravity model which explains the volume of bilateral trade flows between countries. The origins of the model date back to Tinbergen (1962) and Pöyhonen (1963) and the theoretical derivation of the gravity model has been further developed by Anderson (1979), Bergstrand (1985), Deardorff (1995), Eaton and Kortum (2002), Anderson and van Wincoop (2003). Anderson and Wincoop (2003) argue that bilateral trade flows depend on the destination and origin price effects, which are themselves related to the existence of trade barriers, which they call "multilateral resistance". They propose a method which consistently and efficiently estimates gravity equations by controlling for price effects in both the destination and origin markets (and for other regional specificities which would be omitted) by including origin and destination fixed effects in all equations. Since our dataset ranges over time, prices should also change over time. To control for these changes, we therefore include origin and destination fixed-effects, interacted with time dummies.[26]

The analysis requires a variable which would capture the otherwise omitted price effects. Prices are expected to be different in each sector, thus to correctly account for price effects we include time varying country specific fixed effects interacted with sectoral dummies.[27] The following specification is used for the regression:

$$\ln X_{ijkt} = \alpha + \beta_1 \ln PREF_{ijkt} + \beta_2 \ln D_{ij} + \beta_3 Language_{ijt} + \beta_4 E_{itk} + \beta_5 I_{jtk} + \beta_6 T_t + \\ + \beta_7 S_k + u_{ijkt} \quad (1)$$

[24] Cambodia, Laos, Myanmar and Vietnam have later deadlines to implement the CEPT scheme: Vietnam by 2006, Laos and Myanmar by 2008 and Cambodia by 2010.
[25] Data for Thailand for the year 2001 is not available.
[26] See Francois and Woerz (2006) using similar specification.
[27] Chen (2004) also uses sector and country specific fixed effects to capture price effects in each sector and country, however she has a cross-section data and therefore she does not use time varying fixed effects.

The dependent variable $X_{ijkt,}$ is the bilateral import from country i to country j in period t of product k. Country i and j are limited to 5 ASEAN countries, namely, Indonesia, Malaysia, Philippines, Singapore and Thailand and products k are limited to those for which there is an applicable preferential tariff according to the AFTA. The specification is very similar to those of the aggregate regressions. The main difference is that instead of using bilateral preferential tariffs or MFN tariffs, we include the preference margins (the difference between MFN and preferential tariffs relative to MFN tariffs) in the regressions. The variable *PREF* captures the impact of different preference margins on bilateral trade flows, and is constructed in the following way:

$$PREF = \ln \frac{(MFN - PT)}{(1 + MNF)} * Difference \qquad (2)$$

where *PT* is the preferential tariff, *MFN,* the third country tariff, and *Difference* stands for several dummy variables which capture the difference between MFN and preferential tariffs. A total of fifteen dummy variables were interacted with the preference margin, each created for every 5% differential in MFN and preferential rates, all the way up to 50% margin, after which dummies correspond to margins of 10%.[28] The coefficient of the preference margin interacted with these dummy variables, thus indicates the region of tariff differentials where an impact on bilateral trade flows can be expected to take effect. E_{tik} and I_{itk} are time varying reporter and partner fixed-effects interacted with sectoral dummies, while T_t and S_k, correspond to time fixed effects and sector specific fixed effects, respectively.

[28] In other words the fifteen dummies capture when the difference between third country tariffs and MFN tariffs are 0-5%, 5-10%, 10-15%, 15-20%, 20-25%, 25-30%, 30-35%, 35-40%, 40-45%, 45-50%, 50-60%, 60-70%, 70-80%, 80-90%, or more than 90%.

Chapter 3
Rules of Origin for Preferential Trading Arrangements: Implications for AFTA of EU and US Regimes

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With FTAs under negotiation between Japan and AFTA members and between Korea and AFTA members, preferential market access will become more important in Asian regionalism. Protectionist pressures will likely rise with Rules of Origin (ROO), the natural outlet for these pressures. Trading partners in the region would incur unnecessary costs should these FTAs follow in the footsteps of the EU and the US and adopt similar ROO. The utilization of preferences would likely drop if AFTA were to veer away from its current uniform ROO requiring a 40% local content rate. A 10 percentage point reduction in the local value content requirement may increase the utilization rate of preferences by between 2.5 and 8.2 percentage points.

1 Introduction

Rules of Origin (ROO) are integral to the proliferating Free Trade Areas (FTAs) or the non-reciprocal Preferential Trading Arrangements (PTAs) such as the Generalized System of Preferences (GSP). ROO are necessary in any PTA to prevent trade deflection, by which is meant that the country with the lowest external tariff acts as port of entry for the entire bloc's imports, depriving partners of tariff revenue. ROO are about to become important in the trade policy landscape in Asia as at least 45 but possibly up to 70 preferential trade deals will be in existence soon.

Typically ROO are defined at the HS-6 tariff level. However, the Harmonized System (HS) was not designed as a vehicle for conferring origin, its purpose being to provide a unified commodity classification for defining tariff schedules and for the collection of statistics. As a result, devising methods for determining sufficient processing or substantial transformation has turned out to be very complex in all existing PTAs, notably for the two big players, the EU and the US who use the three categories of criteria to determine if sufficient transformation has taken place in activities that require processing: (i) change of tariff classification; (ii) a critical threshold for value-added (in short a 'value content' (VC) rule); (iii) specific manufacturing processes.

Currently, under AFTA, ASEAN-China Free Trade Area (ACFTA) and the other regional Asian FTAs under negotiation (such as those involving Korea and Japan), to obtain originating status (i.e. to fulfil the criterion of sufficient processing), either the "wholly obtained" criterion is used for a few agricultural products or, for the vast majority of products, a single value content rule requiring that 40% of the value of the final product must originate from the countries belonging to the FTA (i.e non-originating imports cannot exceed 60% of the value of the final product) is used in combination with diagonal cumulation (see below). This criterion is remarkably simple compared with the criteria used notably by the two major players, the EU and the US.[1]

However, keeping the present simple system might prove difficult because intra-regional trade is likely to rise sharply as the economies integrate. Given the limits to other forms of protection imposed by WTO membership, the candidate outlet for rising protectionist pressures could be a

[1] The EU uses such a RVC rule-only for 11.46% of its tariff lines, while the US does not use any RVC rule-only.

move towards a complex system of ROO (the US and the EU are often accused of doing so). The question Asian countries may be asking themselves is: should they keep ROO simple or should they switch to a more complicated product-specific ROO which can provide them with some protection.

East Asia is now entering a phase of very active regional integration, which is likely to extend beyond preferences in goods trade. Nevertheless, preferential market access will still be a key component of that regionalism in spite of substantial unilateral tariff reductions. With preferential market access on the rise, and with more trade taking place regionally, the adoption of complex product-specific ROO (PSRO) could turn out to be key in the negotiations of tariff elimination among trading partners. With trade conflicts likely to occur in the region as the volume of trade continues to increase, this conflict could largely play itself over ROO, a trade policy instrument that has so far eluded any discipline from the World Trading System. With the large number of trading arrangements under way, it is plausible that lobbying activities will resemble those involving the US and EU with lobbies in the most powerful partners managing to justify 'made-to-measure' ROO to maximize rent-extraction to their benefit at the expense of the weaker partners.

A move in that direction should be avoided. The experience of the EU and the US shows that complex ROO diminish the value of preferences, in effect reducing the market access that the preferences are intended to provide in the first place beyond what would appear to be "sufficient" transformation to confer "legitimate" origin. AFTA partners should avoid the (tempting) trap of moving towards more complex ROO, and maintain "business friendly" rather than "business owned" ROO.

In this chapter, section 2 details the ROO of the EU (these are the rules that AFTA countries must comply with to benefit from the GSP) and those under NAFTA (a variant of these have been adopted in other FTAs involving the US). Section 3 discusses the economics of ROO and the effects of ROO in NAFTA. Section 4 estimates utilization rate responses to changes in preference margins and in the stringency of the VC rule for AFTA.

2 Rules of Origin in the US and EU PTAs

With the exception of AFTA (and a few others like ANZCERTA and ANZSCEP), ROO in PTAs have two components: a regime-wide set of rules and product-specific rules of origin (PSRO).[2] AFTA has a much simpler set of criteria than most PTAs (Table A1), since it relies only on a minimum share of originating value among partners (which is equivalent to maximum value of non-originating imports).[3] This minimum originating VC applies at the product level so in a sense it is also a PSRO but because it is uniform, in effect it is a level-playing field and AFTA does not have a PSRO. The EU uses the VC criterion extensively, though most often this criterion is used along with other criteria.

For AFTA, the VC rule is also its regime-wide rule. AFTA, like the EU PTAs, also provides for diagonal cumulation which is less stringent than the more usual bilateral cumulation rule applied

[2] These are described in Annex Table A1 which lists the regime-wide rules and Annex Table A2 which shows the PSRO criteria negotiated between Mexico and the US in the context of NAFTA and the so-called PANEURO single-list regime used by the EU in all its PTAs.

[3] More precisely, the RoO requires that the non-originating import content be less than 60 percent of the FOB price of the product where the value of non-originating materials is based upon the CIF import price or the earliest ascertained price for products of undetermined origin.

in PTAs. Under diagonal cumulation, countries tied by the same PTA can use materials that originate in *any* member country as if the materials were originating in the country where the processing is undertaken. However, since the domestic content can be an aggregate of value-added in any ASEAN member state, AFTA provides in effect for full cumulation although, as noted by Brenton (2006), the rules stipulate that the final stage of manufacture must be carried out in the exporting member state (what constitutes 'the final process' is not defined). Because vertical linkages and outsourcing are very important in Asia, full cumulation relaxes considerably the requirements of satisfying origin. Under full cumulation, the more developed, higher labor cost countries can outsource labor-intensive, low-tech, production stages to less developed lower-wage partners whilst maintaining the preferential status of the good produced in the low-cost locations.

Under PANEURO and NAFTA a large list of PRSO criteria are used (Table 1). These typically include technical requirements (such as the triple transformation requirement in textiles and apparel which requires that apparel must be woven from originating fabric and from originating yarn), exceptions, and allowances. NAFTA relies more heavily on a change of tariff classification (CTC), though often accompanied by other criteria. PANEURO relies mostly on a VC and on the "wholly obtained" (WH) criterion (this criterion is not used in NAFTA since Mexicans export far fewer agricultural exports than GSP and ACP countries).

Table 1: Distribution of PSRO under NAFTA and PANEURO (% of tariff lines)

	"No other requirement" or "EXC"		"TECH" or "TECH+EXC"		"VC" or "VC+EXC"		"TECH+VC" or "TECH+VC+EXC"		"Wholly obtained" (WH)		Other additional Requirements		Sub-Total	
	NAF.	PAN.	NAF.	PAN.	NAF.	PAN.	NAF.	PAN.	NAF.	PAN.	NAF.	PAN.	NAF.	PAN.
No CTC	0.5	0.6	0.0	2.6	0.0	13.0	0.0	0.2	0.0	8.1	0.0	7.0	0.5	31.5
CI	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
CS	3.8	0.1	0.4	0.0	0.1	0.4	0.0	0.0	0.0	0.1	0.0	0.4	4.4	1.0
CH	36.3	16.5	0.2	7.8	4.1	12.8	0.1	0.1	0.0	0.3	0.0	13.9	40.7	51.3
CC	48.7	0.0	5.8	7.3	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.2	54.4	7.7
Altern.												8.7	0.0	8.7
Total	89.3	17.2	6.4	17.7	4.2	26.1	0.1	0.4	0.0	8.5	0.0	30.1	100	100

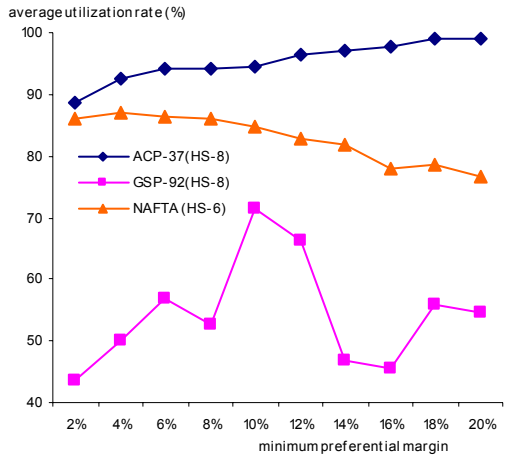
Notes:
Classification is carried out at the HS-6 tariff line level (5595 lines for the EU and 3995 lines for NAFTA). Each cell is the percentage of tariff lines that have the ROO in the corresponding row and in the corresponding column.
CTC = change in tariff classification with CC = Change in Chapter / CH = Change in Heading / CS = Change in Subheading / CI = Change in Item;
EXC = Exception to change of tariff classification;
VC = Regional Value Content; TECH = Technical Requirement.
Altern. = Lines for which importers can choose between alternative criteria.
Source: Cadot et al. (2006a)

3 How Do ROO Affect the Utilization of Preferences?

Do importers end up using the MFN status despite having access to preferences? Average utilization rates of preferences are computed for different thresholds of minimum preferential margins for NAFTA and for the two EU preferential schemes—the Generalized System of Preferences (GSP) for which ASEAN countries (except Singapore) qualify and the Cotonou preferences which benefit the former colonies of the Africa, Caribbean and Pacific (ACP) regions

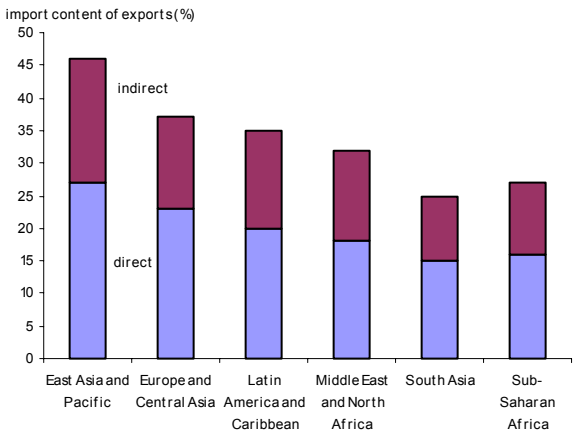
(Figure 1).[4] Since there are administrative costs involved, only preferences above 4% are considered. [5]

Figure 1: Average utilization of preference for different thresholds of preferential margin rates in NAFTA and EU markets (2004)



Note: Preference margin is: (MFN tariff – Preferential tariff)/ (1+preferential tariff); Utilization rates computed at the HS-8 tariff line for GSP and ACP, and at the HS-6 tariff line for NAFTA.
Source: Authors' calculations

Figure 2: Growing vertical integration in the world economy



Source: GEP, World Bank (2005)

First, utilization rates of NAFTA preferences by Mexican exporters are systematically higher than those under GSP for the EU. This could reflect several factors including closer proximity and knowledge of the US market, but also less stringent ROO or greater administrative costs for EU schemes than for NAFTA (e.g. relating to certification methods). The differences in utilization patterns also probably reflect partly differences in the composition of exports.

Second, utilization rates are systematically higher for ACP countries than for GSP countries.[6] This could be explained by better knowledge of procedures (same language for former colonies). However, the combination of higher preference margins and better market access due to less stringent rules of origin are likely to be a determining factor. The regime-wide ROO for ACP countries is less restrictive than for GSP qualifiers since they benefit from full cumulation rather

[4] The reason for distinguishing between GSP and ACP utilization rates is that ACP preferences have been in effect longer; all tariff lines qualify for ACP status; some GSP-eligible countries also qualify for EBA but have chosen not to use the more favorable status (perhaps because these preferences were only in effect since 2002 or finally because of slightly more stringent regime-wide rules for GSP-eligible countries than for ACP countries). All AFTA countries except Singapore qualify for GSP status.

[5] The average preferential margin (computed over tariff lines with positive tariffs) was 4.5% for NAFTA, 2.4% for GSP-eligible countries, and 4.6% for ACP countries (not eligible for EBA status). Almost all tariffs had been eliminated on NAFTA trade by 2001, while 62% of trade took place at zero tariffs in 2004 for GSP-eligible countries and over 80% for ACP countries (some ACP also benefiting from EBA status at zero tariffs in the EU market).

[6] The number of tariff lines is always greater for ACP countries than for GSP countries at any tariff line, even though there are fewer ACP (78) than GSP (92) countries. Of the 78 ACP countries, 41 qualify for Everything But Arms (EBA) status which gave these countries virtually duty-free access to the EU market. However, in 2004, most ACP countries qualifying for EBA status continued to request ACP status. Here the ACP countries refer to the 78 ACP countries.

than diagonal cumulation and they have a more favorable tolerance rule (15% tolerance for all tariff lines instead of 10% and an exclusion of access to the tolerance rule for chapters 50 to 63 which cover textiles and apparel (T&A) for the group of 92 GSP-eligible countries).

Third, utilization rates do not rise monotonically with preference margins. After a point, utilization rates fall as preference margins increase for NAFTA and for the GSP-eligible countries. This is due to a composition effect. In the textiles and apparel sector where preference margins are around or above 10%, utilization rates are low. However, GSP-eligible countries get much less preferential access than ACP countries in the T&A sector (see table 3b). Since these sectors are characterized by specific manufacturing requirements, lobbying activities by the domestic industries in the high-income partner influence the specification of the rules, and the utilization rates are low even though preferential margins are high.[7] Based on an analysis of utilization rate in that sector for NAFTA, Anson et al. (2005) and Cadot et al. (2005 and 2006a), conclude that the PSRO requirements in that sector were designed to leave Mexican exporters on their 'participation constraint', i.e. leaving only marginal rents for Mexican exporters.

Are these utilization rates low? Certainly not by AFTA standards which show utilization rates in the 5%-10% range for the late nineties. Baldwin (2006) argues that this is because the bulk of intra-ASEAN trade is in the computer/machinery (HS-84) and electrical equipment (HS-85) sectors where preferential access market is negligible. However, the use of a VC criterion could also contribute to this low rate of utilization of preferences—even if this requirement does not appear too difficult to comply with, since most parts are produced in the region (at least for the computer hard-disk example). However, the very high import content of exports for the Asia region suggests that AFTA utilization rates could be low because of the present VC limit (Box 1).

Box 1: Importance of trade in intermediates for ROO
Consider the following example recalling that Japan is not currently a member of AFTA. According to the Asian input-output data provided in Baldwin (2006, table 1), for all the middle-income countries (Indonesia, Philippines, Malaysia, Thailand), on average 35%- 40% of intermediates are sourced from outside the AFTA group. Take then an activity with a 10% value-added (this value-added figure is consistent with the deepening of inter-industry flows) and 40% intermediates non-originating. Then, originating value for this activity would be, 64%. But for activities where 60% of materials would be non-originating, originating value would fall to 46%, barely above the stipulated 40% minimum requirement stipulated under AFTA. In the case of the EU, the preference rate for tariff lines where a value-content only criterion is used is lower than for the other tariff lines.

The rather low utilization rates for relatively high preference margins in the EU and US PTAs suggests that this may be due to restrictive PRSO—more restrictive PSRO could be applied to the tariff lines with the highest preferential margins. An ordinal restrictiveness index (the R-index) is computed, taking values in the range $1 \leq r_i \leq 7$ with increasing values corresponding to a more restrictive rule.[8] Though not amenable to quantification like effective rates of protection, the R-

[7] Brenton and Imagawa (2005) mention a case in which NAFTA's ROO for apparel specify that imported fabric must be "of subheading 511111 or 511119, if hand-woven, with a loom width of less than 76cm, woven in the United Kingdom in accordance with the rules and regulations of the Harris Tweed Association, Ltd, and so certified by the Association". Such specific rules are clearly a result of firm-specific lobbying; however, they relatively uncommon.

[8] The index was first proposed by Estevadeordal (2000) for NAFTA. The construction of the R-index is illustrated in the annex and discussed in further detail in Cadot et al. (2006). In addition to the inevitable arbitrariness involved in setting up the observation rule, the R-index has other shortcomings. In particular,

index is intended to play the same role as an effective rate of protection: indicate the restrictiveness that must be met by a product to obtain originating status. Tariff lines with tariff peaks (tariffs lines three times or more the average tariff)—that is tariff lines where preferential margins are the highest—do indeed have a higher value for the R-index than those with low tariffs (Table 2). This is the case for both NAFTA and the EU. Even for non-negligible preferences, utilization rates can be quite low, and the PSRO are, at least partly, designed to discourage the use of preferences. This is particularly true for the textiles and apparel sector where multiple criteria are the norm (Table 3).

Table 2: Protection and the PSRO Restrictiveness Index

	NAFTA		PANEURO	
	R-index	Tariff lines	R-index	Tariff lines
Tariff peaks	6.2	257	5.2	780
Low tariffs	4.8	1432	3.9	3241
Total		3555		4961

Tariff peaks (low tariffs) are calculated for all tariff lines that exceed 3 times (one third of) the average GSP tariff level. ROO indexes are unweighted indexes.
Source: authors' calculations; see annex for methodology

Table 3: Preferences and utilization rates in textiles & apparel (HS-11) (averages, unweighted)

	#Observations	Utilization rate (%)	Preferential Margin (%)
NAFTA (2001)	618	79.9	10.4
GSP (2004)	16555(HS-8) 12920 (HS-6)	52.2	1.8
ACP (2004)	1370 (HS-8) 1175(HS-6)	50	10.4

Source: authors' calculations

Trade among ASEAN countries does not resemble trade among the EU or NAFTA countries. Almost all intra-ASEAN trade is in intermediate products, the final product being sold outside ASEAN. But the picture could change with the proposed FTAs between Japan and AFTA members and between Korea and AFTA members. The resulting trade pattern could involve more inter-industry trade in intermediate and final products and would thus be closer to the one currently observed between the US and the EU and their Southern trading partners. The experience of the EU and US becomes relevant.

4 Decomposition of Costs Associated with ROO

ROO impose costs on the intended beneficiaries of preferences. The compliance costs can be decomposed into distortionary costs (caused by changes in the production structure to be able to comply) and administrative costs (to prove origin). Moreover, there is a loss of rent transfer to exporters (associated with market access) resulting from ROO (Box 2). Therefore, a Philippine producer will export to Thailand under the CEPT scheme on if the preference margin is greater or equal to the cost of compliance.

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it does not control for the degree of preferences and for the characteristics of the different activities: satisfying a CTC involving a CH for intermediate activities is likely to be easier than if it is to be satisfied for a final good activity. Finally, it is an ordinal rather than cardinal measure. For a description of some of the shortcomings of the R-index, see Erasmus et al. (2006).

Box 2: Decomposition of costs associated with ROO

Suppose that a producer in the Philippines wishes to sell a shirt, X_i, under preferential access in another AFTA member, Thailand. This shirt is produced with 'originating' intermediate goods (i.e. with intermediates from other AFTA members and from domestic sources), Z_j^o, but also with inputs from non-originating sources, Z_j^N, say from Bangladesh or India. Let i stand for the shirt and j for the intermediates, say textiles. Omit any taxes paid domestically, and label each input with its own price since intermediates are differentiated products. Let VA_i represent the payments to labor (and to capital or profits). Then the value of final sales is broken down between payments to value added and to intermediate products:

$$P_i X_i = VA_i + P_j^O Z_j^O + P_j^N Z_j^N$$

To obtain originating status, intermediate purchases from domestic producers of textiles and from textile producers in the regional partner countries are counted as 'originating' i.e. $P_j^O Z_j^O$ counts as regional value-added. Then, unrestricted originating value-added expressed as a percent of unit sale (evaluated at FOB prices in the case of AFTA) is given by the expression:

$$va_i^* = \left(VA_i + P_j^O Z_j^O\right) / P_i X_i$$

Assume that to satisfy origin requirements to sell under preferential status in Thailand, the producer in the Philippines is forced to source more originating inputs than he would under optimal circumstances (i.e. in the absence of the PSRO). If an "*" denotes the initial unconstrained (i.e. optimal) choice, and a "c" the constrained choice, then modeling the effects of a binding value content boils down to modeling the implications of:

$$va_i^c > va_i^*$$

In the case of AFTA, $\left(va_i^C \geq 40\%\right)$ is the uniform criterion used to qualify for originating status (although producers also have the option of using other qualifying requirements, notably in the textile and apparel sector where the alternative PSRO were used because the value-content rule was found to be too restrictive). Being forced to use a greater share of originating inputs (or intermediates) results in an increase in producer's unit costs of production to c_1. Let $c_i^D \left(= c_i^1 - c_i^0\right)$ be the cost induced by this distortion. To this, administrative costs, c_i^A, are added. With the product price unchanged, the effect of an increase in unit production costs is to make the producer unprofitable, unless he is compensated by sufficient preferential market access. However, recent estimates show that only a fraction of the rent associated with market access accrues to exporters and that the share of rents they receive is lessened by the presence of ROO. Call the loss of rent transfer associated with ROO, μ_i. Then per unit production cost in the presence of ROO will be the sum of costs in the absence of ROO and compliance costs, c_i^C:

$$c_i = c_i^0 + c_i^D + c_i^A + \mu_i = c_i^0 + c_i^C$$

Under these conditions, the Philippine producer can either export to Thailand under the Common Effective Preferential Tariff (CEPT) scheme where the preferential tariff rate will be given by:

$$\tau_i = \frac{t_i^{MFN} - t_i^{PREF}}{1 + t_i^{MFN}}$$

or under MFN status. Under MFN status, unit price will be 1 and under preferences, $1 + \tau_i$. Since unit profits are given by $\pi_i = P_i - c_i$, if u_i denotes whether or not CEPT preferential status is requested (1=yes; 0=no):

$$\tau_1 \geq c_i^D + c_i^A + \mu_i \quad \Rightarrow u_i = 1$$

$$\tau_1 < c_i^D + c_i^A + \mu_i \quad \Rightarrow u_i = 0$$

In practice, many heterogeneous firms export at the HS-8 level. Thus one will observe a distribution of utilization rates at the most disaggregated HS-8 level. Since there is no data to match firms with utilization rates, the estimation of utilization rates and their correlates in effect assumes that all firms exporting at the HS-8 level are in effect, identical.

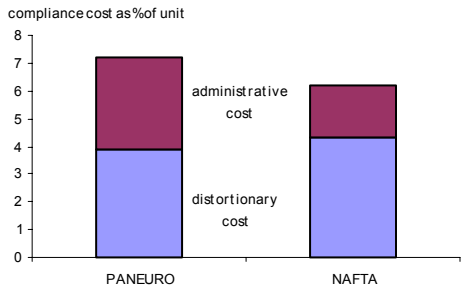
Evidence on the Costs of ROO

It is difficult to estimate the costs associated with ROO because these costs are not observable. Most of the evidence rests on isolating the effects of various PSRO criteria on utilization after controlling for the influence of preferential margins. Carrère and de Melo (2006) assume that the utilization of preferences for product line i is a positive function of the difference between the tariff preference margin, τ_i, and (unobserved) total compliance costs, c_i (expressed as a percentage of unit price) associated with applying the ROO criteria. These assumptions lead to an estimable relation of the form:

$$u_i = \lambda + \alpha\tilde{\tau}_i + \sum_k \theta_k RoO_{ik} + \varepsilon_i$$

where Roo_{ik} is a vector of dummy variables capturing the presence of PSRO (technical requirements, change of tariff classifications, exceptions). Results from this estimation on data from NAFTA by de Melo et. al. (2005) and for the EU by Cadot et al. (2006a) indicate that utilization rates are positively related to preferential margins, and negatively related to the presence of PSRO. Carrère and de Melo combined their estimates with R-index values to compute an estimated ad-valorem equivalent of total ROO compliance costs (administrative and due to higher input costs). Their estimates range from 3.5% for a change of chapter to over 15% for combinations of ROO involving technical requirements. Decomposition of total compliance cost of ROO shows higher estimates for the EU compared with NAFTA (Figure 3). These findings are in line with likely higher administrative costs (perhaps associated with certification) in the EU, and ultimately lower utilization rates.

Figure 3: Decomposition of ROO costs in the EU and NAFTA



Note: Data for NAFTA refer to Mexican exports to the US for 2001. Data for PANEURO refer to request by ACP countries for Cotonou status (data for GSP countries were not used because EBA status was only in place since 2001) . Trade-weighted estimates.
Source: Cadot et al. (2006b).

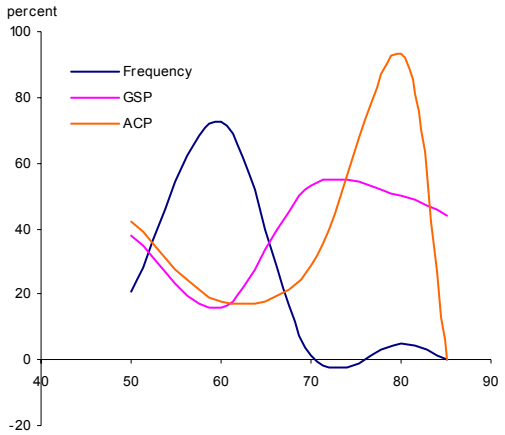
All estimates point in the same direction. When multiple criteria are used to determine origin, utilization rates are, ceteris paribus lower. Moreover, technical requirements tend to be associated with high compliance costs, whereas changes of tariff classification, even at high degrees of aggregation (like a change of chapter) do not seem to have comparably strong effects. This is consistent with the fact that technical requirements can be easily manipulated by special interests, and suggests that broad reliance on a change of tariff classification as a one-size-fits-all origin criterion would be a more desirable direction to go.

The welfare effects of ROO should factor in the rent element associated with preferences and their distribution between the exporting and importing country. This implies estimating the pass-through effect of tariffs on consumer prices (i.e. the extent to which preferences translate into a higher producer price for exporters). Olarreaga and Özden (2005) for AGOA preferences, and Özden and Sharma (2006) for CARICOM preferences estimate that between one-third and one half of tariff reductions are passed on to producers. However, part of the border price increase could just reflect an increase in the complying costs. Cadot et al. (2005) link the pass-through effects of preferences to Mexican producers in the Textiles & Apparel sector under NAFTA directly to rules of origin, and show that once one takes into account ROO, the pass-through effect falls from 80% to about 50%. They also show that US producers of intermediates are able to retain a substantial share of the rents generated by Mexican tariff preferences.

At this stage, AFTA integration has been mostly geared towards supplying products to the outside world, so the rent transfer associated with preferential access has not been an issue. However, as preferential access is bound to increase with the current FTAs under negotiation involving Japan and Korea with AFTA members, protectionist pressures will increase. A pattern of vertical trade along the lines described here would then be likely to emerge between the richer and poorer members in the PTA and the distribution of rents might be mostly tilted towards the more developed partner.

5 Value Content Rules and Preference Utilization: Estimates from the EU Preferential Market Schemes

Figure 4: Value content requirement in the EU and utilization rates of preferences under GSP and ACP



Note: Frequency rates are for tariff lines where value-content is the sole criterion for obtaining origin. Frequency is given in percent
Source: Authors' computation

Currently AFTA has a VC rule. How restrictive is this rule, and how might utilization rates react to a change in the VC rate from the current maximum limit of 60% for non-originating imports to a lower (or higher) rate? These effects are estimated drawing on EU data (because of the great heterogeneity in the data, estimates are confined to tariff lines that rely on a VC rate as the only PSRO). Within the EU ROO, minimum originating value ranges from 50% to 85%, with a bunching around the 60% value (Figure 4).[9] Utilization rates are usually higher for ACP than for GSP, with large variations in utilization rates in spite of relatively small variations in preferential margins that are quite low. For AFTA, the closest VC rate is the 50% RVC rate where the utilization rate for ACP and GSP is around 40% for a preferential margin of 2.6%.

How would utilization rates of preferences change if the value content rule changes? Utilization rates as an increasing function of preferential margins and a decreasing function of the originating value content are estimated (Box 3) and the results are shown in Table 4.

The mean utilization rates are low for the tariff lines used in this estimation, suggesting that value content criteria are rather restrictive. Estimated utilization rates are slightly higher for GSP-eligible countries than for ACP countries. Since estimates are influenced by omitted variables, it is best not to speculate on this small difference in utilization rates across samples. All signs of estimated coefficients are as expected. Since the variable for the VC is the minimum regional value content, the negative sign estimate indicates that, as expected, a higher minimum regional value content lowers utilization rates.

[9] For the wholly obtained criterion, originating value has to be 100%. Since this criterion only applies to agricultural products and is not relevant to the AFTA context, is it not considered here.

Box 3: A model for estimating the impact of changes in value content on utilization rates

Assume that the profit rate for product line i, π_i is an increasing function of the preferential margin, τ_i, and a decreasing function of the originating value content, vc_i,:

$$\pi_i = \alpha_0 + \alpha_1 \tau_i + \beta_1 vc_i + \varepsilon_i$$

where the anticipated signs for the parameters or interest are: $\tilde{\alpha}_1 > 0$; $\tilde{\beta}_1 < 0$. There is no observable measure of this benefit, so it is a "latent variable". What is observed instead is the utilization rate, u_i which obeys the following law:

$$u_i = \begin{cases} 0 & \text{if } \pi_i < \pi_0 \\ f(\pi_i) & \pi_0 < \pi_i < \pi_1 \\ 1 & \text{if } \pi_1 < \pi_i \end{cases}$$

for some function *f* and bounds π_0 and π_1. For simplicity, assume a linear form for *f*, so that u_i is in the range where it is not "censored" at zero or one. This leads to the model:

$u_i^* = \alpha_0 + \alpha_1 \tau_i + \beta_1 vc_i + \varepsilon_i$

$u_i = 0 \quad if\ u_i^* \le 0$

$u_i = u_i^* \quad if\ 0 \le u_i^* \le 1$

$u_i = 1 \quad if\ u_i^* \ge 1$

where u_i^* is the latent utilization rate and u_i is the observed one.

A reduction in the maximum regional content from 60% to 50% leads to an increase in the estimated utilization rate by 2.5 percentage points (from the estimated mean of 17 percent) in the case of GSP and by 8.2 percentage points (from the estimated mean of 13 percent) in the case of ACP. With a smaller sample including only tariff lines with preference rates exceeding 5%, utilization rates are less sensitive to a change value content rate at tariff lines with higher preference rates (last three columns in Table 4).

What utilization rates would be for preferential rates in ACFTA? Chinese and Philippine average MFN tariff rates are used to proxy for the extent of likely preferential market access for ASEAN exports into China and the Philippines, or vice-versa. In these illustrative simulations, the VC is set to the AFTA level (40%), which is likely to be the VC rate under ACFTA. Predicted utilization rates are higher when using the Chinese MFN tariff, which is more than twice as high as the Philippine one (Figure 5).

Because of the very different pattern of trade between the EU and its GSP and ACP partners and the ruling patterns of trade in AFTA/ACFTA, it is difficult to conclude whether these ex-ante simulated utilization rate responses to changes in VC and in preferential margins could be used as guides to the likely effects under AFTA/ACFTA. Furthermore, the estimated coefficients values are sensitive to the choice of controls, and the estimates were only carried over the sample of tariff lines where the VC was the only criterion used to determine origin. Therefore, it is probably best to retain from the exercise that utilization rates could be quite sensitive to changes in VC requirements and preferential margins.

Table 4: Determinants of utilization rates for EU preferential schemes (tariff lines with RVC rule only)

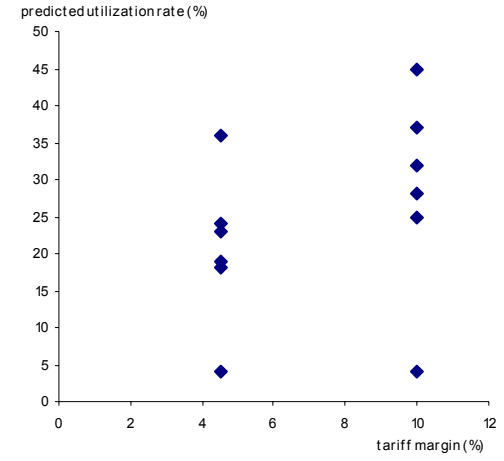
Dependent variable=u_i	(GSP+ACP)	(GSP)	(ACP)	(GSP+ACP)	(GSP)	(ACP)
Constant	1.58 (4.52)***	1.7 (4.99)***	14.88 (10.68)***	0.43 (-1.01)	0.97 (2.36)**	10.61 (6.38)***
τ_i (tariff preference for GSP)	0.077 (12.74)***	0.066 (10.89)***		0.05 (5.35)***	0.026 (2.80)***	
$\ln(vc_i)$	-0.632 (7.47)***	-0.59 (7.14)***	-4.069 (11.66)***	-0.309 (3.06)***	-0.351 (3.56)***	-2.936 (6.96)***
τ_i (tariff preference for ACP)			0.043 (10.00)***			0.03 (6.06)***
Number of Observations	19261	13448	5857	5958	4305	1697
Likelihood Ratio [a]	263.43(0)	198.83(0)	222.3(0)	47.48(0)	25.5(0)	71.68(0)
Sample restriction	$(\tau_i \geq 2\%)$	$(\tau_i \geq 2\%)$	$(\tau_i \geq 2\%)$	$(\tau_i \geq 5\%)$	$(\tau_i \geq 5\%)$	$(\tau_i \geq 5\%)$
Change in utilization rate due to a 10% reduction in VC from 60% to 50%	2.0%	2.5%	8.2%	5.2%	1.7%	7.9%
Mean preference margin (%)	3.74	3.79	5.09	5.14	5.22	9.78
Mean utilization rate (%)	12	17	13	17	22	20
Mean value content (%)	58.8	58.9	58.6	58.2	58.6	57.5
		Simulated utilization rates				
Assumed value for rvc_i	40	40	40	40	40	40
Mean MFN tariff (China)	10	10	10	10	10	10
Predicted utilization rate	0.32	0.37	0.45	0.25	0.28	0.40
Mean MFN tariff (Philippines)	4.5	4.5	4.5	4.5	4.5	4.5
Predicted utilization rate	0.19	0.23	0.40	0.18	0.24	0.36

Source: Authors' computations

[a] The reported likelihood ratio follows a chi-squared distribution with two degrees of freedom $\left(\chi^2(2)\right)$. The p-value of this statistic is reported in brackets. The overall fit for the models summarized in the likelihood-ratio values are reasonable.

Note: To avoid giving excessive weight to tariff lines with small trade flows, tariff preferences were aggregated using imports as weights from the HS-8 to the HS-6 level where the value content rates are specified. In addition, to minimize measurement error, an average of utilization rates over the whole period for which data were available was used (2002 to 2004) and GSP (including EBA) beneficiaries and ACP beneficiaries were considered separately because of the systematically differential utilization rates. To reduce the effects of omitted variable bias, only tariff lines where VC was the only criterion used were considered (this would correspond most closely to the current ROO in Asian PTAs). Finally because of administrative costs, estimates were restricted to tariff lines with preferential margins in excess of 2% or 5%. Estimates in columns 1 and 4 are carried over the whole sample, with the other columns referring to separate estimates for GSP and ACP recipients.

Figure 5 : Range of predicted utilization rates for Philippines and China using different parameters



Note: The two cases for tariff margins are the mean MFN tariff for China (10%) and for Philippines (4.5%); the assumed value content is 40%.
Source: authors' calculations

5. Lessons from NAFTA and the EU PTAs

In any preferential trading arrangement (PTA) short of a Customs Union, ROO are necessary to prevent trade deflection. Typically, the vast majority of PTAs use three methods to establish if sufficient transformation or substantial transformation has taken place: (i) change of tariff classification; (ii) a critical threshold for value-added; (iii) specific manufacturing processes. The EU and the US use these three methods often relying on multiple requirements at the product level. The evidence from the US and EU experience suggests that ROO have indeed restricted access because ROO have been designed to protect sectors in the EU and the US that would be most affected by preferences. Overall, ROO have been more restrictive than would have been necessary to satisfy the sufficient transformation criterion, with as a consequence low utilization rates in sectors like textiles and apparel where preferential margins were usually high.

The more detailed evidence on the costs of the PSRO in NAFTA and the EU suggests that administrative costs are likely to be non-negligible (though positive imports in tariff lines with zero or small tariff preferences are observed). Distortionary costs created by ROO have even proven harder to quantify, although the low rates of utilization in the textiles and apparel sector attest to their presence. Econometric evidence shows that, after controlling for the preference margin, utilization rates are lower in sectors characterized by multiple ROO requirements. It also suggests that in the textiles and apparel sector where vertical linkages are important, ROO reduce substantially the rent transfer towards exporters which are intended by preferences in the first place. Thus, North-South PTAs, which correspond to those currently under negotiation in the ASEAN, are likely to yield negligible benefits for the low-income partners if ROO are not simple enough.

Using a large sample of tariff lines where the sole criterion used was a value content (VC) criterion, utilization rates are estimated as a function of preferential margins and VC rates. The results of the estimation show that higher regional VC rates are indeed associated with lower utilization rates after controlling for the effects of preferential margins on the utilization rate. A reduction in the regional value content from 60% to 50% is estimated to increase utilization rates by between 2 and 8 percentage points. If the many uncontrolled other factors influencing utilization rates were the same under the AFTA agreements than under the EU GSP and ACP PTAs, then the current 40% VC rate might give rise to a utilization rate between 20% and 40% under AFTA depending on the extent of preferential margins.

On the basis of this evidence, it is argued that forthcoming regional PTAs in Asia (e.g. ACFTA, Japan-ASEAN and ASEAN-Korea) could well face pressures for shifting to the complex criteria characterizing the EU and US PTAs. These pressures should be resisted, and the ASEAN regional trading agreements under negotiation should stick to the relatively simple current rule requiring a non-originating import content of less than 60% or less of the FOB price of the product under

what is in effect full cumulation. If this transparent rule is potentially costly for small firms in poor countries because of its requirements in terms of accounting, it has the advantage of being unambiguous, it bypasses the need for Product-specific Rules of Origin (PSRO) and does not give leeway to lobbying activities by domestic industries over the specification of rules.

Annex

Regime-wide rules: These usually include: (i) a *de minimis* (or tolerance) criterion which stipulates a maximum percentage of non-originating materials that can be used without affecting the origin of the final product; (ii) cumulation[10]; (iii) roll-up[11]; (iv) duty-drawback[12];(v) certification method.

Virtually all PTAs require PSRO. These typically involve, among others, a change of tariff classification (CTC) that can take place at different levels (Table A1). AFTA stands out as the exception since it does not use a CTC to confer origin. Like all PTAs, AFTA relies on a regional value content (RVC) criterion. Compared with others, the criterion is relatively lenient. Most PTAs rely on specific manufacturing processes (also known as technical requirements) which apply mostly to trade in textiles and apparel. So far, since most of the production in textiles and apparel in Asia is directed towards the rest-of-the-world, this criterion has understandably not made its appearance. Finally, again with the exception of AFTA, all PTAs have a tolerance limit (i.e. a percentage of imported inputs that are not counted as non-originating and an absorption rule).[13]

[10] Cumulation allows PTA producers to import non-originating materials from other PTA member countries without affecting the final product's originating status. Three types of cumulation rules are distinguished: bilateral, diagonal and full cumulation. Bilateral cumulation is most common and applies to trade between two partners in a PTA. It stipulates that producers in country A can use inputs from country B without affecting the final good's originating status provided that the inputs are themselves originating (i.e. provided that they themselves satisfy the area's ROO). Under diagonal cumulation (the basic principle of the EU's PANEURO system and under AFTA), countries tied by the same PTA can use materials that originate in *any* member country as if the materials were originating in the country where the processing is undertaken. Finally, under full cumulation, all stages of processing or transformation of a product within the PTA can be counted as qualifying content regardless of whether the processing is sufficient to confer originating status to the materials themselves. It is easy to show that full cumulation allows for greater fragmentation of the production process than the more commonly used bilateral and diagonal cumulation, and hence is less restrictive.

[11] The absorption or roll-up principle allows non-originating materials which have acquired origin by meeting specific processing requirements to maintain this origin when used as input in a subsequent transformation. In other words, the non-originating materials are no longer taken into account in calculating value added. The roll-up or absorption principle is used in most PTAs (in particular the EU's GSP and Cotonou), although a few have exceptions for the automotive sector.

[12] Duty drawbacks are refunds to exporters of tariffs paid on imported intermediate inputs. Many PTAs, especially in the Americas, mandate the elimination of duty-drawback schemes for exports to partner countries, on the ground that a duty drawback claimed by a producer in A to export to B would put that producer at a competitive advantage compared to domestic producers in B given that the A-producer already benefits from the elimination of intra-bloc tariffs. The elimination of duty drawbacks as part of a PTA's formation can imply a cut in the profitability of final-good assembly for export to partner countries in the area, although tariff escalation, when present, already provides some protection for final-assembly operations (as it implies lower tariffs on intermediate goods than on final ones).

[13] The PTAs also differ in the way certification is carried out (either single or double certification and either public or private with the option that in some cases such as NAFTA certification needs only be carried out for one shipment rather than all shipments.

Product-specific rules (PSRO): Besides regime-wide ROO, PSRO determine eligibility at the tariff-line level.[14] Two basic criteria are used to determine origin: the "wholly obtained" (WH) and "substantial transformation" criteria. The first criterion applies mainly to products which have been entirely grown, extracted from the soil or harvested within the country of export, or manufactured there from any of these products. Therefore it applies when only one country enters into consideration in attributing origin.

The second criterion, "substantial transformation", is more complex and is used for all tariff lines representing products with processing. It involves either of the following alternatives (which can be used as stand-alone but usually in combination with each other):

- Change of Tariff Classification (CTC), requiring the product to belong to a tariff classification different from that of its imported inputs. The change of tariff classification can be expressed at various levels of aggregation: from broader to narrower, chapter (HS 2 digits), heading (HS 4 digits), sub-heading (HS 6 digits), or item (HS 8 digits). Changes of classification expressed at broader levels of aggregation are, in principle, more constraining.
- Regional Value Content (VC) requirement, requiring the product either to acquire a minimum percentage of local value added in the exporting country or not to exceed a maximum percentage of foreign (non-originating) materials. The VC criterion is largely used by the EU, but not much by the US.
- Technical Requirement (TECH), requiring the product to undergo certain manufacturing operations in the exporting country or prohibiting the use of certain inputs.
- Exceptions (EXC) can be attached to a particular CTC, which prohibits the use of non-originating materials from a certain subheading, heading, or chapter.
- Allowances, on the contrary, permit the use of non-originating materials from certain classifications.

Measuring restrictiveness: The complexity of regime-wide rules is extended to the PSRO. Table A1 describes the PSRO for NAFTA and for all the EU PTAs. It also includes the value of a restrictiveness index r_i, $(1 \leq r_i \leq 7)$ for each type of restriction which is then used to construct an overall index or restrictiveness for the regime (R-index).

[14] The Harmonized Commodity Description and Coding System, commonly known as "HS Nomenclature", is an international multipurpose nomenclature elaborated under the auspices of the World Customs Organization. Although only 116 countries are Contracting Parties to this Convention, more than 190 administrations worldwide apply the US nomenclature, mostly to set up their national customs tariff and for the collection of economic statistical data. The HS Nomenclature comprises 20 sections further subdivided into 96 chapters (commodity group identified by 2-digit code). Chapters are subdivided into headings (4-digit codes) and subheadings (6-digit codes, about 5000 of them), where the harmonization stops. Some administrations such as Eurostat use finer (up to 10 digits) classifications.

Table A1: PSRO in NAFTA and PANEURO
(calculated at the HS-6 level tariff line)

	Distribution across tariff lines (in percent)		ROO index[a]
Requirement	**PANEURO**	**NAFTA**	
NC	0.39	0.54	1
NC+ECTC	2.39		1-2
NC+TECH	1.39		2
NC+ECTC+TECH	0.00		2
NC+VC	11.46		4-5
NC+ECTC+VC	1.57		5
NC+VC+TECH	0.08		7
NC+WH (CHAPTER)	7.62		1
NC+WH (HEADING)	0.70		1
	25.60	*0.54*	
CI			
CI+ECTC		0.02	1
CI+TECH			
CI+ECTC+TECH			
CI+VC			
CI+ECTC+VC		0.02	2
CI+VC+TECH			
SUBTOTAL	*0.00*	*0.04*	
CS	0.20	1.29	2
CS+ECTC	0.00	2.52	2
CS+TECH	1.90	0.04	2
CS+ECTC+TECH	0.00	0.40	2
CS+VC	0.27		3
CS+ECTC+VC	0.00	0.10	3
CS+VC+TECH	0.00		3
CS+ECTC+VC+TECH	0.00		3
	2.37	*4.35*	
CH	32.99	17.09	4
CH+ECTC	4.60	19.18	4
CH+TECH	0.00	0.02	4
CH+ECTC+TECH	6.66	0.14	4
CH+VC	13.01	3.54	5
CH+ECTC+VC	0.37	0.58	5
CH+VC+TECH	0.00	0.10	5
CH+ECTC+VC+TECH	0.02		5
	57.65	*40.65*	
CC	2.16	30.95	6
CC+ECTC	1.02	17.71	6
CC+TECH	0.04	0.02	6
CC+ECTC+TECH	11.02	5.76	6
CC+VC	0.00		7
CC+ECTC+VC	0.00		7
CC+VC+TECH	0.00		7
CC+ECTC+VC+TECH	0.00		7
	14.24	*54.44*	
TOTAL	100	100	

Sources: Anson, Cadot, Estevadeordal, de Melo and Tumurchudur (2005, Table 1)
NC= No change; ECTC=exception to change of tariff classification; TECH= technical requirement; VC= value content; CI=Change of item; CS= change of subheading; CH=change of heading; CC=change of chapter
[a] The index r_i is calculated at the HS-6 level following Estevadeordal (2000) and takes a value in the range $1<r_i<7$, a higher value indicating a more restrictive ROO.

The "observation rule" for the above is based on the following two assumptions:

1. The restrictiveness of a change of Tariff Classification (CTC) can be ranked in terms of its restrictiveness on the basis of the following observation: A change of classification at the chapter level (CC) has to be more difficult to satisfy than a change at the Heading (CH) level; likewise, a change at the heading level has to be stricter than at the subheading (CS) level, and a change at the subheading level more stringent than at the tariff line or item level (CI). This implies that the following observation rule (larger values corresponding to more restrictiveness):

$$\Delta CC > \Delta CH > \Delta CS > \Delta CI$$

2. More criteria usually imply a more restrictive rule. Thus, if a CTC is widely used in both NAFTA and PANEURO, in the majority of cases, it is almost always accompanied by other criteria to be met to confer origin. All but allowances make it more difficult to satisfy origin, so the observation rule assigns higher values to the index resulting from the CTC when these other requirements are added on (and a lower value when there is an allowance). Further details on the construction of the R-index (computed for 3,555 tariff lines for NAFTA and 5,595 tariff lines for PANEURO) are given in Cadot et al. (2006a).

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PART II

COUNTRY STUDIES: RULES OF ORIGIN FACED BY EAST-ASIAN EXPORTERS

Chapter 4
Cambodia

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Cambodia is a least developed country (LDC) with a per capita GDP of $448 in 2005. Over the past ten years, growth averaged 8.2 percent per annum, resulting in a decline in the poverty rate from 47 percent in 1993 to 35 percent in 2004. But growth is narrow-based and driven by only few industries—garment, tourism, and construction—with the agriculture sector experiencing booms and busts.

As part of its strategy for trade development and economic growth, Cambodia was eager to integrate itself into regional and global trading systems. It became a member of ASEAN in 1999 and a member of the WTO in 2004. Owing to its LDC status, Cambodia receives preferential schemes such as Generalized System of Preferences (GSP) and ASEAN Integration System of Preferences (AISP) from developed and developing countries which allow potential Cambodian products to access international markets at zero or low tariffs.

While external markets for exports are largely open, Cambodian exports are still limited in terms of products and destinations. Garment exports account for more than 90 percent of all exports. Nearly 90 percent of total exports are directed to the US and the EU. The recorded agricultural exports are minimal. Cambodian exports to other destinations, including countries providing GSP schemes, are also minimal.

1 Export Profile

Cambodian exports are limited in terms of products and destinations. The main exports are garment and textile which historically came to being as a result of the preferential schemes granted by the US and the EU. These preferential treatments made the US and the EU the main destinations for Cambodian exports, accounting for nearly 90% of total exports during 2000-05 (Figure 1). In contrast, exports to ASEAN countries are minimal while it is observed that informal exports to neighboring countries are significant. Exports to Canada and Japan—which also benefit from GSP schemes there—accounted for 2.8 percent and 1.5 percent of total exports respectively during 2000-2005.

Exports of garments, shoes and textile products accounted for 92 percent of total exports during 2000-2005 (Figure 2). The US absorbs about 70 percent of total garment exports while the EU absorbs about 25 percent. Most of the rest are exported to Canada and Japan. The garment industry has rapidly grown since 1997 when the country was granted MFN status by the US and signed a cooperation agreement including trade cooperation with the EU. Following these agreements, the country was awarded GSP and quota schemes by the EU and the US in 1999, allowing it to access these markets duty free.

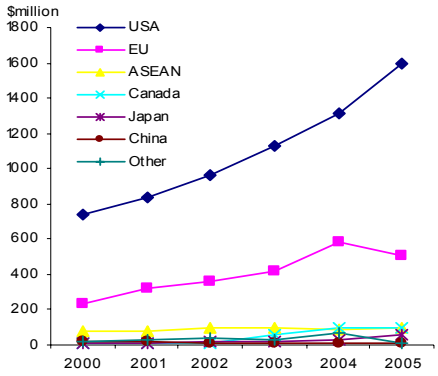
With those agreements, investments in the garment sector flowed significantly into the country. Between 1996 and 2005, the number of garment factories operating in the country jumped from just 24 to 247 and exports grew from just $80 million to $2.2 billion. Even after the phase out of the Multi-Fiber Agreement (MFA) quota system in 2005 under the WTO agreement, garment exports to the US continued to increase as the country had built a strong comparative advantage based on its reputation of good labor and working rights for their buyers. Safeguards on China

until 2008 have also helped Cambodian garment exports to the US and EU markets. Garment exports to ASEAN are minimal.

In Cambodia, garment production involves mainly cut-make-trim (CMT) activities with almost zero backward linkages to fabrics and accessories. Cambodia offers relatively cheap labor, relaxed investment law, and benefits from GSP schemes granted by developed and developing countries. The country lacks a textile industry and most inputs are imported from China, Hong Kong, Taiwan and Korea whose nationalities are the majority of garment factory owners operating in Cambodia. All produced garments are for exports.

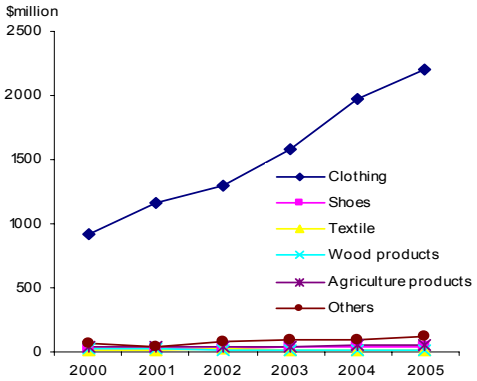
Cambodia is an agriculture-based economy. About 60 percent of Cambodians are employed in this sector and its share is more than 30 percent of GDP. It is estimated that production of some agricultural products has a surplus for exports but most of it is informally exported in the form of raw and unprocessed products. The recorded agricultural exports include wood products, rubber, fish products and rice and account for merely 3.4 percent of total exports.

Figure 1: Cambodia's main export destinations



Note: Exports to Japan sharply increased in 2005 due to exports of antiques older than one hundred years.

Figure 2: Cambodia's main export products



Note: Wood products include timber, plywood, veneer; Agriculture products include rubber, fish products, rice.

Source: *EIC, reproduced from data of Ministry of Economy and Finance*

2 Cambodia's Preferential Agreements

Free Trade Agreements (FTAs) with Cambodia. Since 1999, Cambodia has become a member of ASEAN through which it has committed to implement the common effective preferential tariff (CEPT) within the ASEAN Free Trade Area (AFTA). Under the AFTA framework, the original ASEAN-6 member (Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore and Thailand) will eliminate import duties no later than 1st January 2010 while the new ASEAN-4 members (Cambodia, Laos, Myanmar and Vietnam or CLMV) will eliminate their tariffs not later than 1st January 2015, with flexibility allowed for import duties on some sensitive products to be eliminated no later than 1st January 2018.[1] Cambodia's sensitive list contains only 54 tariff lines, all agro-products. Currently, Cambodia is negotiating free trade agreements through the ASEAN framework with a number of countries such as ASEAN-China, ASEAN-Japan, ASEAN-Korea, ASEAN-India, ASEAN-Australia and New Zealand and ASEAN-EU (Table 1).

[1] Protocol to amend the agreement on the Common Effective Preferential Tariff (CEPT) Scheme for the ASEAN Free Trade Area (AFTA) for the elimination of import duties. http://www.aseansec.org/14183.htm

Cambodia and the Generalized System of Preferential (GSP). As a LDC, Cambodia was given unilateral tariff preferences, commonly known as GSP scheme, by a number of countries in favor of developing exports of less developed countries (Table 2). A GSP scheme does not automatically increase market access to a country giving GSP as a range of conditions apply—including rule of origin, requirements of importing countries, and buyers' preferences—limiting the ability to use the preferences.

Under the AFTA initiatives for economic integration, ASEAN has developed its own GSP scheme called ASEAN Integration System of Preferences (AISP) scheme. Under the AISP scheme, old ASEAN members grant AISP to CLMV, except Singapore since its MFN rate is equal to zero. The AISP scheme has the following main purposes:

- ✓ To accelerate the integration of CLMV into ASEAN,
- ✓ To narrow the development gap among ASEAN member countries under the IAI framework,
- ✓ To promote greater exports of CLMV to the ASEAN-6.

Table 1: Cambodia's involvement in FTAs through the ASEAN framework

Partner	Title	Scope	Status
Japan	ASEAN-Japan Comprehensive Economic Partnership	Goods, services, investment liberalization by 2012; facilitation; economic and technical cooperation.	Negotiations commenced April 2005; commitments to conclude within two years
Australia/ New Zealand	ASEAN-Australia and NZFTA	Comprehensive for goods, services and investment within ten years	Agreement in November 2004 to establish an FTA by 2007
India	ASEAB-India CECA	Goods expected to be completed by end of 2005; services and investment; DS mechanism	Framework Agreement signed in October 2003; negotiations to finalize FTA on goods by end 2005; to establish DS mechanism by end 2005
Korea	ASEAN-Korea FTA	To expand two-way trade and investment by liberalizing and integrating markets; at least 80% of goods at zero tariff by 2009	Negotiations commenced early 2005; scheduled to be completed by end 2006
China	ASEAN-China CECA Framework	FTA on goods by 2010 for ASEAN-6; FTA for services trade and investment to be implemented within mutually agreed timeframes; Early Harvest program for tariff elimination on selected products; cooperation in other areas	Frame work agreement entered into force on 1 July 2003. Early harvest program completed. Normal track started in July 2005.
EU	ASEAN-EU FTA	The Vision Group on ASEAN-EU Economic Partnership was established by ASEAN Economic Ministers and the EU Trade Commissioner at their 6th Consultation on 27 April 2005. The Vision Group was to look into the feasibility of possible ASEAN-EU FTA and other new initiatives for enhancing cooperation and ties between ASEAN and the EU. The feasibility study also covers the scope of negotiation of ASEAN-EU FTA.	The feasibility study on a possible ASEAN-EU FTA was completed in May 2006 and submitted at the 7th AEM-EU consultation in May 2006. The report recommends that an ASEAN-EU FTA should be established as well as principles and scope for ASEAN-EU FTA negotiations. The ministers exchanged views on the recommendations put forward in the report and welcomed the recommendations to take the ASEAN-EU Economic Partnership to a higher level through the establishment of WTO consistent FTA and expansion of cooperation to ensure benefits of the FTA are maximized and balanced.
Source: *EIC, compiled from WTO Trade Policy and Annual Report (2006) of the Ministry of Commerce*			

The AISP scheme offers unilateral concessions by preference-giving countries. The scheme is not subject to negotiation and is based on the commitments of preference-giving countries. The

number of tariff lines (TL) given AISP is subject to annual reviews of AISP-giving countries and receiving countries are required to submit a new list of AISP requests by 1st June of each year to be considered for the following year.

Table 2: Countries granting GSP treatment to Cambodia

Country	Title of GSP scheme
Australia	Australian System of Tariff Preferences (ASTP)
Bulgaria	GSP Scheme of the Republic of Bulgaria
Canada	Least-Developed Country Tariff treatment (LDCT)
China	Special Preferential Treatment (SPT)
Estonia	GSP Scheme of the Republic of Estonia
EU	Everything But Arm (EBA)
Japan	GSP Scheme of Japan
Republic of Korea	Presidential Decree on Preferential Tariffs for Least-Developed Countries
New Zealand	Scheme of Generalized Preferences of New Zealand
Russian Federation	GSP Scheme of the Russian Federation
Turkey	GSP Scheme of Turkey
Switzerland	GSP Scheme of Switzerland
Source: EIC, compiled from UNCTAD and Ministry of Commerce	

In 2001 Cambodia requested 862 tariff lines to be included in the AISP list with a preferred GSP rate of zero. Cambodia gradually obtained GSP preferences under the AISP scheme, from 173 tariff lines in 2003 up to 632 tariff lines in 2005 of which 77 percent were given zero duty and 23 percent were subject to a 5 percent duty (Table 3). Of the 632 tariff lines, 293 tariff lines are textile and apparel, 113 tariff lines are wood and wood articles, 101 tariff lines are agro-products and the remaining is furniture, jewelry, paper products, paint and varnishes.

Table 3: Status of AISP given to Cambodia

	Brunei	Indonesia	Malaysia	Philippines	Thailand	Total
No of AISP TL requested (2001)	8	249	164	99	342	862
No of AISP TL given (2005)	8	40	180	64	340	632
No of AISP TL given at 0%	8	10	180	64	225	487
No of AISP TL given at 5%	0	30	0	0	115	145

Note: Singapore has zero MFN tariffs.
Source: *EIC, reproduced from reports from the Economic Integration and ASEAN Department of the Ministry of Commerce*

In 2002, China provided preferential tariffs to Cambodia under the Special Preferential Treatment (SPT) initiative. SPT covered 297 products and came into effect at the beginning of 2004. In December 2005, China decided to grant Cambodia preferential tariffs for an additional 83 products—bringing the total tariff lines covered by SPT to 380.

3 Preferential Agreements and Rules of Origin

Rules of origin associated with preferential treatment given to Cambodia's exports vary according to countries (Table 4).

Since the MFA was phased out in 2005, exports to the **US** enter at MFN rates and are hence not subject to any requirements of rules of origin.

Since early 2001 Cambodia's garments have been exported to the **EU** under the Everything But Arms initiative (EBA) which enables Cambodian exports to benefit from duty free entry if they meet the EU's rules of origin. To be eligible for duty free (i) a product must be wholly obtained in

Cambodia, or (ii) a product constructed of originating inputs from the EU, ASEAN, SAARC and ACP countries must have more than 50 percent value added in Cambodia. The eligible products are certified by certificate of origin form A, which allows those products to access the EU markets duty free.

Given the fact that Cambodia lacks a textile industry, most fabrics and accessories are imported from China, Hong Kong, Taiwan, and Korea. With this production profile, only 61 percent of garment export values to the EU in 2004 were eligible for certificate of origin form A; also, most of those eligible garments used regional cumulation within ASEAN and SAARC. Recent figures released by the EU confirm that EBA's utilization rate by Cambodian exports reached 63.3 percent.[2]

The criteria for **Canada**'s GSP rules of origin are more relaxed. As an LDC, Cambodia is able to import materials from undetermined countries up to a value of 60 percent of ex-factory price. Based on interviews with government officials, almost all exports to Canada under the GSP scheme are able to obtain a certificate of origin of form A with duty free access.

Cambodian exports benefit greatly from **Japan**'s GSP scheme. In 2005, 1,565 certificates of origin of form A to Japan were issued, with a value of $26 million. Total exports to Japan under the GSP/MFN scheme amounted to about $27 million in the same year. Thus, the utilization rate is about 96 percent.

Table 4: Overview of rules of origin in Cambodia's main export destinations

Countries	Criteria
EU (EBA)	1. Goods are wholly obtained in Cambodia. 2. Goods constructed of materials originating in the EU, ASEAN, SAARC or ACP countries; inputs must have more than 50% value added in Cambodia.
Canada	1. Goods are wholly obtained in Cambodia. 2. Goods whose imported content is not more than 60% of the ex-factory price.
Japan	1. Goods are wholly obtained in Cambodia. 2. Where goods are produced partially from materials imported from other countries, there must be a Change in Tariff Classification (CTC) between resulting products and non-originating materials or parts used in production. 3. Goods whose materials are imported from Japan to be used in production are considered as wholly obtained in Cambodia 4. ASEAN countries are considered as one preference-receiving country.
ASEAN	1. Goods are wholly obtained or produced in Cambodia. 2. Goods whose contents are originating from any ASEAN members and which have at least 40% value added.
Source: *EIC, compiled from various sources.*	

Cambodia can access preferential treatment in **ASEAN** in two ways: through the CEPT scheme and the AISP scheme. Exports eligible for CEPT require a certificate of origin (form D) for obtaining the preferential tariff. Exports eligible for AISP require a different certificate of origin (form AISP). The AISP rules of origin are different from those for CEPT, and they also differ among the ASEAN countries providing the preferences (Table 5).

[2] Presentation by Carlos Bermejo Acosta, EU trade representative, during the European Commission Media Seminar on 02-03 February 2006, Phnom Penh, Cambodia.

Table 5: AISP rules of origin

Country	AISP Rule of Origin
1. Brunei	40% of combined local content of ASEAN member countries
2. Indonesia	40% of combined local content of ASEAN member countries
3. Malaysia	40% of combined local content of ASEAN member countries
4. Philippines	40% of single country content
5. Thailand	40% of combined local content of Thailand and each CLMV country

Source: *presentation by Dr. Pola Singh (18 May 2006), Former Head of IAI unit, ASEAN secretariat*

4 Use of Preferences with ASEAN and China

Cambodian exports to ASEAN are minimal, accounting for 5.1 percent of total merchandise exports during 2000-2005. The country's merchandise is exported mainly to Vietnam, Singapore, Thailand and Malaysia. The major export products to ASEAN are rubber, wood articles, garments, gems and jewelry—which account for about 67 percent of total exports to ASEAN. Exports to China accounted for less than 1 percent of Cambodia's total exports during 2000-2005 even though the country received preferential treatment under the SPT initiative.

Most exports to ASEAN are agricultural products which qualify for the rule of origin "wholly obtained". There is also a certain amount of garment products exported to ASEAN which qualify for CEPT using regional cumulation. Interviews with garment factories exporting to ASEAN countries reveal that some garments are exported into ASEAN because buyers try to avoid re-export from their headquarters (in the US or EU) to a third country (in ASEAN). For instance, a factory produces garments in Cambodia to supply its headquarters in the UK. The global company establishes a branch in Thailand to sell garments under its global brand. Instead of exporting to the UK and re-exporting to Thailand, garments produced in Cambodia for this company are exported directly from Cambodia to Thailand.

The majority of Cambodian exports to ASEAN are not covered by preferential tariffs under the CEPT and AISP schemes, but they do enjoy low MFN rates. A number of export products to ASEAN benefit from AISP scheme. These products are mainly agricultural products such as corn, soybean, tapioca starch, peanuts and sesame. The value of exports under the CEPT and AISP preferential schemes is minimal. In 2005, the export value under both AISP and CEPT accounted for $10 million, in which exports under AISP accounted for $9.5 million and under CEPT for about $0.5 million.

A sample accounting for 76 percent of total exports to ASEAN shows that 90 percent of these exports (or 68 percent of total exports to ASEAN) have a zero margin of preference between MFN and CEPT and are not included in AISP lists (Table 6). These products enjoy the existing low MFN rates of 0-5 percent, while Cambodia's export in other tariff lines with high margins of preference is still limited. Only 23 certificates of origin of form D, with an export value of $0.5 million, were issued in 2005; and only 45 certificates of origin of form AISP, with an export value of $9.5 million, were issued in the same year (AFTA bureau of the Ministry of Economy and Finance).

Similarly, the utilization rate of preferences under China's SPT program remains very low. According to data from the Ministry of Commerce (MoC), there were only six SPT certificates of origin issued in 2005. These exports were all agricultural products and amounted to $94,200. The field survey for this study revealed that some export companies face high tariffs from neighboring countries giving preferential treatments where that tariff line is not included in the agreements (Box 1).

Box 1: Palm Wine Spiked with High Tariffs despite Preferential Agreements

Confirel Co., Ltd. produces a whole range of products made from the unique Cambodian palm tree including palm wine, sugar palm, crystallized products and palm hat. These products are supplied to both local and external markets. The majority of exports are directed to France and other EU countries, which make up 75 percent of its sales profit. The company can access EU markets duty free under the Everything But Arms (EBA) arrangement.

As part of its strategy to gain market penetration, the company first exported palm wine to Vietnam in July 2005. The company had to pay a 65 percent tariff on these exports since the palm wine was not included in CEPT list and there is no agreement for low-tariff access between Cambodia and Vietnam. This makes the product uncompetitive in the Vietnamese market and therefore the company stopped exporting to Vietnam.

Likewise, confirel is not able to access the Chinese market since it needs to pay a 93 percent tariff, making the undertaking unprofitable. Palm oil is excluded from the list of 297 products to which China unilaterally granted low-tariff access under the Special Preferential Treatment (SPT).

Source: *Authors based on The Cambodia Daily Newspaper, p. 18, July 13th, 2005 and Interviews with the General Manager of Confirel Co, Ltd. in June 2006.*

Table 6: Margins of Preference (MOP) for main export products in 2005

Export products by HS (8 digits)	% of Exports to ASEAN	MFN Rates	CEPT Rates 2005	MOP*	AISP
Vietnam					
Other crepe rubber	29.3%	3%	3%	0%	No
Reclaimed rubber in primary forms or in plates, sheets or strip	1.9%	3%	3%	0%	No
Wood (excl. of 4407.10-4407.92), sawn/ chipped LW, sliced/peeled, WN planed, sanded/end-jointed of a thickness >6mm	6.3%	0%	0%	0%	No
Other – Articles of plastics & arts. of other mats. of 39.01-39.14, n.e.s. in Ch.39	0.8%	20%	5%	15%	No
Other – Woven fabrics of acrylic/ modacrylic staple fibers, other than that mixed M/S with M-M filaments/wool/fine animal hair	1.3%	40%	10%	30%	No
Thailand					
Trout, fresh/chilled (excl. fillets/other fish meat of 03.04/livers & roes)	0.6%	5%	5%	0%	No
Soya beans, whether or not broken	1.7%	6%	5%	1%	0%
Containers for compressed or liquefied gas, of iron or steel	0.7%	10%	5%	5%	No
Worn clothing and other worn articles	0.7%	30%	0%	30%	No
Vehicles (excl. of 87.02 & 8703.10) principally destined for the transport of persons, with spark-ignition int. comb. recip. piston engine, of a cylinder capacity >1500cc BN >3000cc	2.7%	80%	5%	75%	No
Malaysia					
Palm oil, crude	0.6%	0%	0%	0%	No
Natural rubber other than latex/smoked sheets/technically spec. nat. rubber	2.8%	0%	0%	0%	No
Knitted or crocheted fabrics	0.6%	15%	5%	10%	No
Sub-Total	49.2%	-	-	-	-
Singapore (all tariff lines)	26.7%	0%	0%	0%	No
Total (% of total exports to ASEAN)	75.8%	-	-	-	-
Total exports with MOP=0% (% of total exports to ASEAN)	68%	-	-	0%	No

* Margin of Preference (MOP) is the difference between MFN rates and CEPT Rates in 2005.

Source: *Authors' calculations based on data from Ministry of Economy and Finance and www.aseansec.org*

5 Conclusion and Recommendations

Current major exports to ASEAN are benefiting little from the CEPT and AISP preference schemes. This is mainly due to the fact that they are already enjoying low MFN rates of 0-5 percent. Exports under tariff lines with a high margin of preference are still limited. The country also benefits little from China's SPT scheme. Taking into account the case of palm oil exports to Vietnam and China, the recommendation for negotiations on the AISP and SPT schemes would be to focus on tariff lines where exports are currently taking place rather than a list of many non-exported products.

While the latter market access problems are not due to rules of origin, Cambodian exports are also facing barriers in this respect. These barriers are preventing the country from fully benefiting from preferential treatment. The case of the garment industry clearly demonstrates that Cambodia cannot benefit fully from the EU's EBA initiative due to the absence of a local textile industry and the EU's criteria being tied up with specific regions which are not the main sources of Cambodia's garment inputs.

Regional cumulation plays a crucial role in helping Cambodian exporters meet the rules of origin. The Cambodian textile industry is underdeveloped and most fabrics and accessories are imported, mainly from China, Hong Kong, Taiwan and Korea as well as some from ASEAN and SAARC countries. The importance of regional cumulation becomes evident in the case of the EU. The EU's rules of origin criteria are restrictive with respect to imports of fabrics and accessories from ASEAN and SAARC countries. As a result, in 2004 only 61 percent of the garments exported to the EU qualified for duty free access. Garment exports to Japan and ASEAN have in the past benefited more from regional cumulation of origin.

Cambodia will need to proceed carefully with free trade agreements, especially through the possible enlargement of ASEAN. The region is in the process of setting up free trade agreements with other countries, such as China, the EU and Japan, where Cambodian exports are currently facing NTBs. Thus, if the FTA negotiations do not take into account the specific country experiences, Cambodia's benefits from those FTAs could be limited.

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Chapter 5
China

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In November 2002, China and ASEAN signed a framework agreement "aimed at the establishment in 2010 of an FTA between the two parties". According to this agreement, China and the six countries of ASEAN will abolish almost all tariffs by 2010 and create a vast FTA. This is a big change on the part of China, which had been very cautious about FTAs. The so-called ACFTA is a milestone in China's FTA policy change.

The establishment of a free trade area between China and ASEAN will create an economic region with 1.8 billion consumers, regional GDP of about $5 trillion and total trade estimated at $4 trillion in 2010. It will be the biggest FTA in the world in terms of population size. It will also be the largest FTA, made up of developing countries, in terms of population, GDP and trade.

This paper focuses on rules of origin (ROO) in ACFTA and their impact on Chinese exporters. It draws on a survey of Chinese exporters conducted during February-May 2006 in Beijing, Shanghai, Shandong, Liaoning, Hubei and Guangxi. The paper compares different kinds of ROO in China's FTA negotiations and agreements and highlights the main concerns of Chinese exporters based on the survey.

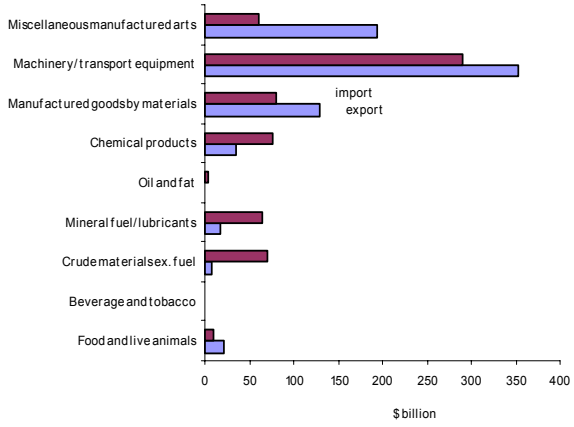
It is early to assess ROO in ACFTA and its impact on Chinese exporters, because the tariff reduction of industrial products of ACFTA only started on July 20, 2005. Up to now, a very small number of enterprises feel an impact from the ACFTA ROO on trade creation, trade transformation, services and investment, outsourcing, etc. Moreover, statistical data and company complaints have not yet been available in the governmental collections. This limits the assessment of the ACFTA ROO and would require further study in the future.

1 China-ASEAN Economic Relationship

Before the 1980s, the volume of China's foreign trade was very small. In 1981, China's total import/export volume was $44 billion, implying a rank of 32 amongst the largest traders in the world. Since then, China has seen rapid foreign trade growth, driven by its rapid economic growth and open policy. In 2005, China's total foreign trade reached $1.42 trillion, 23% higher than the previous year, making it the world's 3rd largest trader. China's main export and import products are machinery and transport equipment (Figure 1).

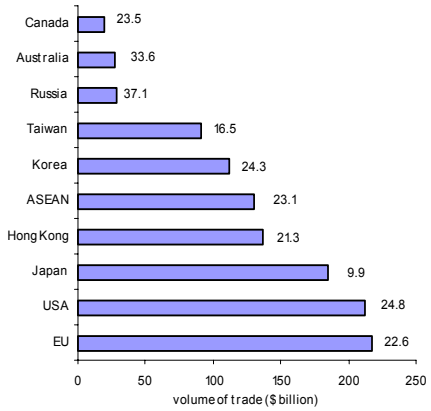
In recent years, ASEAN's importance as China's trading partner has been increasing—accounting for 9 percent of China's trade and ranking as China's 5th largest trading partner (Figure 2). China and ASEAN have doubled their bilateral trade in the past 3 years, reaching $130 billion in 2005. With the high growth rate continuing, bilateral trade may well double to $300 billion by 2010. Among the ASEAN countries, Singapore, Malaysia, Thailand, the Philippines, Indonesia and Vietnam have the closest trade relations with China, and their trade growth rate with China has been very high in recent years. Even as individual countries, Singapore and Malaysia ranked 7th and 8th respectively among China's trade partners in 2005. Trade with ASEAN countries is diverse in terms of products (Table 1).

Figure 1: China's main exports and imports, 2005



Source: UN COMTRADE

Figure 2: China's top trade partners, 2005 (figures next to bars are 04/05 growth rates)



Source: UN COMTRADE

Table 1: China's most important export and import commodities in individual ASEAN countries, 2005

	Import	Export
Indonesia	Petroleum oils and oils obtained from bituminous minerals other than crude, iron and steel, machinery, electromechanical products, electrical appliances, audiovisual equipment and components thereof, automobiles and spare parts, chemicals, textile materials such as woven fabrics of cotton and filaments, alliaceous vegetables, apples and pears	Petroleum oils and oils obtained from bituminous minerals, coal and other minerals, electronic equipment and auxiliaries, electromechanical products, electric and electronic products and components thereof, organic chemicals, rubber, wood and articles of wood, paper and paperboard, palm oil and its fractions
Malaysia	Cereal, machinery and electronic products, textile yarn and products thereof, clothing and accessories, steel, crude oil, footwear and vegetables	Machinery and electronic products, palm oil, plastics, natural rubber, unprocessed wood, product oil, steel and crude oil
Philippines	Electric products, electronic products, semi-conductor devices, electronic integrated circuits and micro-assemblies, product oil, cereals and cereal powders, coal, textile yarn and products thereof	Electronic integrated circuits and micro-assemblies, semi-conductor devices, electrical and electronic products, inductors and parts, bananas, fresh and dried fruits, nuts, processed oil
Singapore	Electric power machinery and parts, audio-video equipments and parts, machinery and parts, fossil fuels, mineral oils and their products, optical and medical equipments and parts, iron and steel and their products	Electric power machinery and parts, audio-video equipments and parts, machinery and parts, fossil fuels, mineral oils and their products, plastics and products, organic chemicals, rubber and products
Thailand	Electric power machinery and parts, computers and parts, cloth, household electrical appliances, mineral products and metal scrap, integrated circuits, daily necessities	Computers and parts, plastic resin, natural rubber, crude oil, chemical products, cassava products, integrated circuits, iron and steel products, timber and products thereof, LPG
Vietnam	Fossil fuels, mineral oils and their products, machinery and equipment, steel and related products, chemical fertilizers, cotton, textile products, garments and accessories, and motor vehicles.	Minerals, minerals oils and their products, rubber and related products, electrical machinery and equipment, audio-video appliances and their spare parts, timber and timber-work, fruits, furnaces, mechanical devices and their spare parts.

Source: Ministry of Commerce

2 China's Free Trade Agreements

ASEAN and China concluded negotiations on their FTA in 2004 and will effectuate the free trade between the two regions by 2010. The ACFTA contains a modality for tariff reduction and elimination for tariff lines both on a normal track and a sensitive track. Within the normal track there are three sets of schedules. The first applies to ASEAN-6 and China. The implementation began on 1 July 2005, when applied MFN tariff rates were brought down to 20%, 15%, 10% and 5% for tariffs above 5%. By 2007 they will be reduced to 12%, 8%, and 5%, and by 2009 to 5% and 0%, and finally by 2010 all rates will become 0. The second schedule applies only to Vietnam, where all tariffs will be brought down to 0% in 2015. The third schedule applies to Cambodia, Laos and Myanmar, where some tariffs will still be higher than those in Vietnam's schedule, but from 2011 onwards they will be the same. With a view to accelerate cooperation, the parties are in the meantime implementing an Early Harvest Program mainly focused on agricultural products.

Besides the ASEAN countries, China is seeking to establish bilateral FTAs with New Zealand, Australia, Pakistan, the Southern African Customs Union (SACU), the Gulf Cooperation Council (GCC), the Andean Community, the Southern African Development Community (SADC) and a plurilateral FTA with Japan and Korea; it has signed FTAs with Chile and Pakistan (Table 2). The total number of countries (and regions) involved in China's FTA negotiations and discussions exceeds 40.

Table 2: China's FTAs

In effect	Negotiation finished or under negotiation	Under discussion
Hong Kong	Australia	India
Macao	New Zealand	Iceland
ASEAN	Singapore	Korea
Pakistan	Thailand	Japan
Chile	Gulf Cooperation Council (Saudi Arabia, UAE, Kuwait, Oman, Qatar and Bahrain)	Russia
	Southern African Customs Union (SACU: Botswana, Lesotho, Namibia and Swaziland (the so-called BLNS countries) and South Africa)	Ukraine
		Mongolia
		Shanghai Cooperative Organization (SCO: China, Russia, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan)
		Andean Community (Peru, Bolivia, Ecuador, Colombia and Venezuela)
		South Africa Development Community (SADC: Angola, Botswana, Zimbabwe, Lesotho, Malawi, Mozambique, Namibia, Swaziland, Tanzania, Zambia, South Africa, Mauritius, Congo (Kinshasa) and Seychelles)

Source: Ministry of Commerce

3 Rules of Origin in China's Free Trade Agreements

Rules of Origin (ROO) are an important element of preferential trading agreements. According to the WTO, ROO are used to determine whether imported products shall receive most-favored nation (MFN) treatment or preferential treatment, and to implement measures and instruments of commercial policy such as anti-dumping duties and safeguard measures, as well as for the purpose of trade statistics, for the application of labeling and marking requirements, and for government procurement.

Preferential ROO can be used to protect sensitive sectors in an economy. If they are restrictive, they can distort trade, investment and production patterns by distorting the global supply chain. ROO can act like trade barriers, since they cause extra costs in production and management. Producers/exporters pay extra costs for calculating production costs and producing bookkeeping related documents. Also, additional costs are incurred in complying with technical and specific process and regional value contents, and these costs will be added to prices of export goods.

Rules of origin in China: institutional responsibilities. In China, institutions dealing with the ROO regime include the Ministry of Commerce (MOFCOM), the General Administration of Customs (GAC), and the General Administration of Quality Supervision, Inspection and Quarantine (AQSIQ). MOFCOM is responsible for the regulations regarding ROO and is supported by GAC; GAC checks origin of imported goods, and AQSIQ issues ROO certificates to Chinese exporters. The China Council for Promotion of International Trade (CCPIT) and its local branches, and other big companies/institutions also issue ROO certificates authorized by MOFCOM. In China's FTA negotiations, ROO teams are always led by MOFCOM, with participants from GAC and AQSIQ (Table 3).

Table 3: Division of responsibility among government institutions for ROO

	MOFCOM	GAC	AQSIQ	CPPIT/Others
General	Making Rules	Checking Origin of Imported Goods	Issuing Origin Certificates to Chinese exporters	Issuing Origin Certificates to Chinese exporters
ACFTA	Making Rules	Checking Origin of Imported Goods	Issuing Origin Certificates to Chinese exporters	No
Other FTAs	Making Rules	Checking Origin of Imported Goods	Issuing Origin Certificates to Chinese exporters	To be decided

Source: author's compilation

Non-preferential rules of origin in China: In December 2004, China passed the "Regulations of the People's Republic of China on the Country of Origin of Imports and Exports." The regulations, embracing 27 articles, have been implemented since 1 January 2005. The regulations replace the old version promulgated by the State Council on 8 March 1992 and the Provisional Rules of Origin of the Customs General Administration of China for Imports which came into effect on 6 December 1986. The regulations determine the country of origin of imports and exports with respect to non-preferential trade measures such as MFN treatment, anti-dumping and countervailing duties, safeguard measures, origin marking requirements, country-specific quantitative restrictions and tariff quotas; as well as activities like government procurement and trade statistics.

China's general rules of origin for import and export are non-preferential rules of origin. Under current arrangements, and in accordance with the criteria, when an imported product is processed and manufactured in several countries, the country of origin of the product is determined to be the last country in which the product undergoes substantial transformation. China's current non-preferential rules of origin are divided into two categories:

1. **Import Rules of Origin:** used for the application of MFN rates, for compiling trade statistics, for marking of origin, for import control, and will be used for anti-dumping duties, countervailing duties, safeguard measures, and tariff quota.
2. **Export Rules of Origin:** used for export control, for compiling trade statistics and for marking of origin.

Where the production of the goods has taken place in several countries/areas, the country/area carrying out the last substantial processes economically is regarded as the original country of the goods. The "substantial processes" means that, after processing, the tariff heading of a product has been changed in the "Customs Import and Export Tariff", or the percentage of the value-added reaches 30 percent or more of the whole value of the new product. The "substantial processes" are used as the basic principle of current rules and "value added" criteria are used as supplementary rules.

The list of procedures of manufacturing and processing is formulated and adjusted by the national relevant departments in charge of foreign economic relations and trade, in consultation with the concerned departments of the State Council.

Box 1: Comparison of different rules of origin

For the purpose of negotiations over non-preferential rules of origin for goods produced with inputs from more than one customs territory or contracting member, the WTO adopted the general principle that a change in tariff headings is sufficient to confer origin. That is, the origin of a product undergoing processing in more than one member country is conferred upon the place of "last substantial transformation" of the product in question. The Uruguay Round Agreement on Rules of Origin contains a non-binding "Common Declaration with Regard to Preferential Rules of Origin" (Annex II, Agreement on Rules of Origin, 1994:218) to the effect that members refrain from adopting rules of origin with protective intentions that may harm the interests of third countries.

There are several standard rules of origin followed in FTAs, but none is completely satisfactory. The traditional support for the value added approach was based on its (i) simplicity (the same rule can be applied to all traded products); (ii) neutrality (the rule is not affected by the sensitivity of the products in question and is not subject to political concerns over specific industry policies); and (iii) fairness (the percentage threshold is a fair measure of local transformation of imported materials). However, it has become apparent that the value added approach does not necessarily guarantee simplicity and transparency in evaluating the origin of traded products. The calculation of costs may be time-consuming and administratively burdensome (all allowable costs being legislated), with manufacturers required to maintain records of all production activity and costs. This in turn may lead to disagreements over what are allowable costs and how they should be apportioned across traded and non-traded goods.

The traditional support for the Change in Tariff Classification (CTC) rule of origin was based on its objectiveness—there is a single, clear rule for each tariff line. For the vast majority of products for which the rule of origin requires only a CTC test, there is no issue with exchange rates, fluctuating world prices or the need to enter into debates with Customs officials over allowable and non-allowable costs, price mark-ups or allocation of operating overheads across production. The CTC is a more predictable approach, less difficult to administer and easier for small and medium-sized enterprises (SMEs) to understand while requiring less record keeping and calculations. However, opponents of this system argue that the existing tariff schedules were not designed to determine the origin of the goods and that the system may be abused by strong industrial lobbies.

Other rules of origin also have drawbacks. The Regional Value Content (RVC) method depends on controversial accounting systems and even a slight change in the exchange rate may produce a different result. The minimum area content requirement is criticized on the grounds that it shifts the product factor mix away from the optimum, reduces rationalization in production, and may reinforce market rigidities. The special Technological Process (TP) method has problems emerging from the fact that technology changes rapidly and it is impossible to draft and keep updated records on processes for all goods that enter into international trade.

Most FTAs employ multiple criteria for setting ROO, rather than a single rule. According to the WTO (2002), while ROO in many FTAs are based on CTC, RVC and TP are also widely used. Combinations of the three methods are widely used in an FTA. Many FTAs such as NAFTA require substantial CTC, making their ROO complex. ROO will become more complex and stringent when ROO specifies a combined requirement of CTC and RVC. NAFTA, EU-Mexico FTA, and FTA by Japan and Korea introduce this type of ROO for sensitive items. NAFTA is the first FTA with comprehensive coverage including trade, investment, services and trade rules. In promoting FTAs, the US has imposed quite stringent ROO based on the change of heading, specific requirements for HS chapters, and complicated criteria for the regional value content. CTC in chapter, heading and subheading is most widely used, with additional requirements of specific process and regional value contents. De Minimis rule is 7% in NAFTA, lower than in other FTAs.

Source: Palmeter, David "Rules of Origin in Regional Trade Agreements" in *Regionalism and Multilateralism After the Uruguay Round—Convergence, Divergence and Interaction*, European Interuniversity Press, Brussels, 1997.

Comparison of preferential rules of origin in China's FTAs. Rules of origin in FTAs differ widely (Box 1). China has used different ROOs for different FTAs. The simplest ROO was chosen for ACFTA, and it seems that a similar rule may be used as the basis for China's FTAs under negotiation.

The ACFTA has a simple and quite liberal ROO, which is 40% RVC. It is similar to that in AFTA. The criterion of 40% RVC was introduced by AFTA, when the Common External Preferential Tariff (CEPT) scheme was agreed upon in 1992. During the negotiations for an FTA between China and ASEAN, China accepted the AFTA ROO and concluded the negotiations at the end of 2004. The ROO for the ACFTA as stipulated in the Agreement (Annex 3) is as follows—"a product shall be deemed to be originating if: (i) not less than 40% of its content originates from any Party; or (ii) the total value of the materials, parts or produce originating from outside of the territory of a Party (i.e. non-ACFTA) does not exceed 60% of the FOB value of the product so produced or obtained provided that the final process of the manufacture is performed within the territory of the Party." In addition, the ACFTA Rules of Origin allow for cumulation provided that the aggregate ACFTA content, i.e. full cumulation, applicable among all Parties, on the final product is not less than 40%. Also, products that satisfy the Product Specific Rules, i.e. products that have undergone sufficient transformation in a Party, will be treated as originating goods of that Party. Cheong (2005) observed that the ROO in AFTA and ACFTA, which specify 40% RVC across all items, is the simplest ROO in the world (Table 4).

Table 4: ROO in Main FTAs in the World

	ACFTA	AFTA	Japan-Singapore	Korea-Chile	NAFTA	EU-Mexico
CTC	Not necessary	Not necessary	Yes	Yes	Yes	Yes
RVC	40%	40%	60-40%	45-30%	60-50%	50-30%
Cumulation	Yes	Yes	Yes	Yes	Yes	Yes
De Minimis	No mention	No mention	8-10%	8%	7%	10%

Source: trade agreements

In CEPA, Hong Kong maintains its current zero-tariff policy towards goods imported from the Mainland, with staged tariff elimination for goods imported by China from Hong Kong. China agreed to introduce zero tariffs for a list of goods specified in Annex 1 as of January 1, 2004. Full elimination of bilateral tariffs will occur no later than January 1, 2006. All goods have to meet CEPA rules of origin (details on these rules are in Annex 2 of the Agreement). Imports claiming origin must be accompanied by a valid Certificate of Origin. To acquire Hong Kong origin a product must have 30% value added in Hong Kong (this includes the value of raw material, labor costs, component parts, and product development costs). Foreign companies in Hong Kong may export goods to China under CEPA if the products meet the value added requirement. The ROO in the Macao CEPA are almost identical to the Hong Kong CEPA, only the lists of goods in Annexes 1 and 2 differ in some areas. The China-Chile and China-Pakistan FTAs use the same ROO criteria—40% RVC. In China's other FTAs under negotiations, it may be expected that the 40% RVC will be used as the basic principle for the ROO (Table 5).

Table 5: ROO in China's FTAs

	CTC	RVC	TP	Cumulation	De Minimis
CEPAs	Not necessary	30%	No	Yes	No mention
China-ASEAN	Not necessary	40%	No	Yes	No mention
China-Chile	Not necessary	40%	No	Yes	8%
China-Pakistan	Not necessary	40%	No	Yes	No mention
China Australia (est.)	Not necessary	40%	No	Yes	8% est.
China-New Zealand (est.)	Not necessary	40%	No	Yes	8% est.

Source: trade agreements

The originating criteria set out in ACFTA ROO are referred to as the "ACFTA content". The formula for the 40% ACFTA content is calculated as follows:

$$\frac{\text{Value of non-ACFTA materials} + \text{Value of materials of undetermined origin}}{\text{FOB Price}} \times 100\ \% < 60\%$$

Therefore, the ACFTA content: 100% - non-ACFTA material = at least 40%

ACFTA uses Form E as the originating certificate. When the Early Harvest Program (EHP) started in late 2003, China began to issue ACFTA originating certificates. In 2004, China issued 11543 certificates with a value of $148 million on vegetables and fruits. Because tariff reduction of industrial products began on July 20, 2005, China issued more ACFTA certificates in 2005. The number of issued certificates reached 38,370, with a growth rate of 332%, while their value reached $411 million with a growth rate of 278% in 2005. Very few industrial products were included in the EHP. In 2005, the number of Form E certificates on electric power machinery and parts, electronics, audio-video equipment and parts, etc, was only 469 with a value of $6.5 million, representing less that 2 percent of the volume and value of Form E certificates (Figure 3).

Though Form E trade grew quickly in 2004 and 2005, its percentage in China-ASEAN trade remained very small. In 2005, total Form E trade was around $0.4 billion or less than 0.5 percent of total China-ASEAN trade (Table 6). China's Form E trade with Vietnam and Thailand was highest among ASEAN countries both in 2004 and 2005.

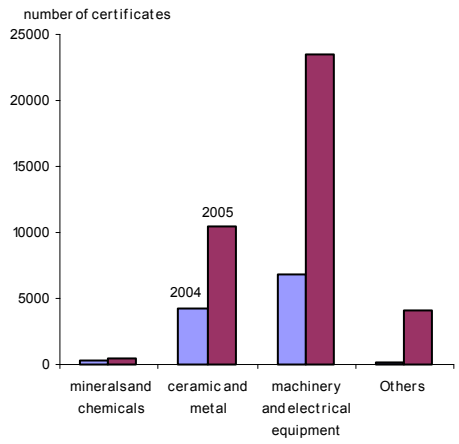
Table 6: Form E trade in China-ASEAN trade in 2004 and 2005

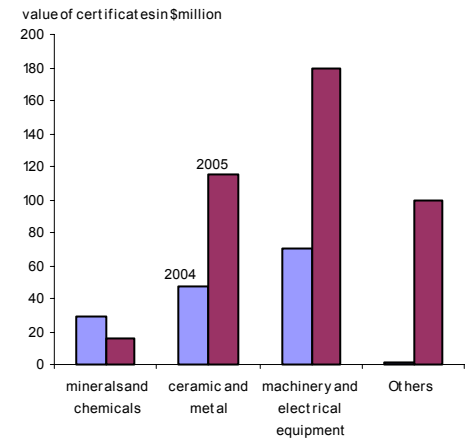
	2004			2005		
	Total trade	Form E trade		Total trade	Form E trade	
	($billion)	Value ($million)	Share in total trade	($billion)	Value ($million)	Share in total trade
ASEAN	105.9	148	0.14%	130.4	411	0.32%
Singapore	26.7	3	0.01%	33.1	7	0.02%
Malaysia	26.3	6	0.02%	30.7	46	0.15%
Thailand	17.3	84	0.49%	21.8	155	0.71%
Philippines	13.3	0	0.00%	17.6	0	0.00%
Indonesia	13.5	20	0.15%	16.8	111	0.66%
Vietnam	6.7	33	0.50%	8.2	78	0.95%

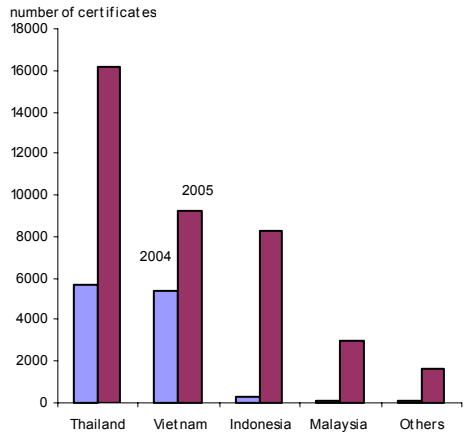
Source: Ministry of Commerce

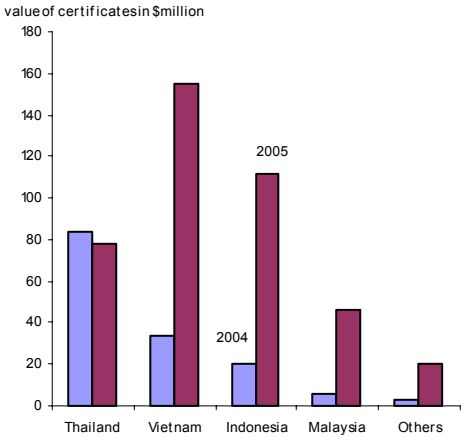
The reasons for the low utilization of Form E could be: (1) a small margin of preference; (2) lack of awareness; and (3) cumbersome process. A survey of about 20 companies conducted in April 2006 in various parts of China (Beijing, Dalian, Qingdao, Wuhan, Shanghai, Guangdong, and Guangxi) suggests that most firms have not experienced difficulties in meeting the ACFTA rules of origin and have not modified their input sourcing in order to meet the ACFTA rules of origin. The absence of impact of the ACFTA rules of origin on Chinese exporters as captured by the survey may be due to the fact that tariff reduction on industrial products began only in July 2005, so not enough time has elapsed for Chinese exporters to use the preferential rates.

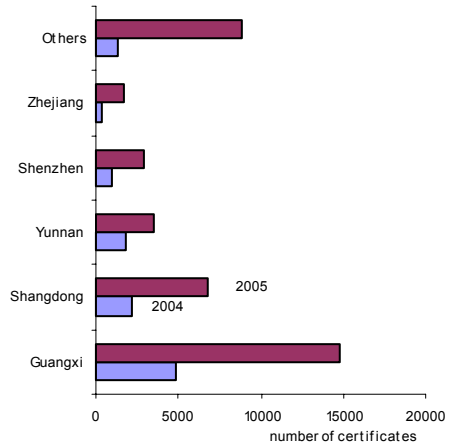
Figure 3: Form E certificates—number and value by type of product, ASEAN country, and Chinese province

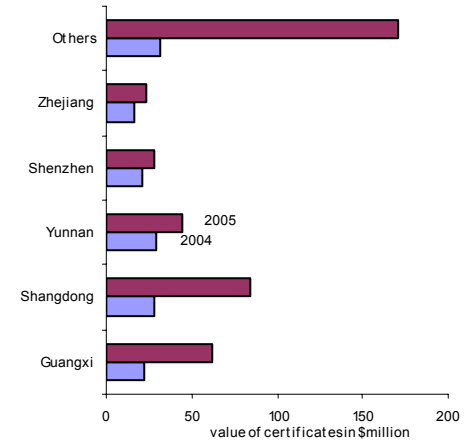












Source: Ministry of Commerce

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Chapter 6
Indonesia

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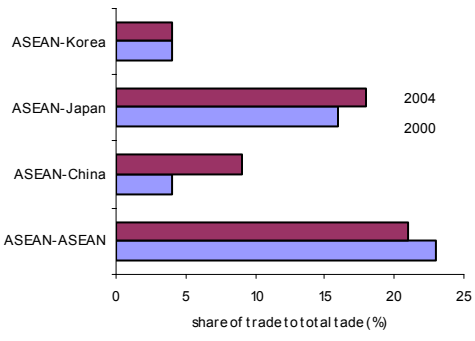
In the post Asian financial crisis, regionalism in East Asia became an increasingly attractive option to manage external challenges (Chia Siow Yue, 2006). Beginning with ASEAN, the regional trade arrangement expanded to include ASEAN+1 agreements (ASEAN plus one country, currently China and South Korea and soon Japan, India, Australia-New Zealand) and ASEAN+3 (China, Japan and South Korea).

While this regional economic integration effort could potentially benefit the region, the concern remains about how the details of the regional trade arrangements should be worked out. A crucial issue embedded in regional free trade area is the rules of origin. Due to its preferential nature, each preferential trade arrangement applies a set of rules of origin. Rules of origin define eligibility of certain commodities to get the preferential treatment. There are at least 4 broad methods applied to determine the origin of certain goods: (i) wholly obtained; (ii) change of tariff classification; (iii) value added; and (iv) specific manufacturing process. ASEAN adopted the wholly obtained and value added rules; in some cases a specific products rule of origin also applies but is limited to only a few products, namely textile and garments, wood products, wheat flour, and steel.

1 Trade Profile in ASEAN and Indonesia

ASEAN intra-regional trade has increased substantially, but remains limited compared to ASEAN global trade. ASEAN intra-regional trade almost tripled since AFTA was first launched. Intra-ASEAN imports increased from $33 billion in 1992 to $89 billion in 2004. During 2000-2004, intra-ASEAN trade grew by 5 percent (Figure 1). Compared to its global trade, intra-ASEAN trade remains limited—it increased from 17 percent of ASEAN global trade in 1992, to 23 percent in 2000. Four years later, in 2004, it was still at 23 percent.

Figure 1: ASEAN trade with selected partners



Source: UN-COMTRADE

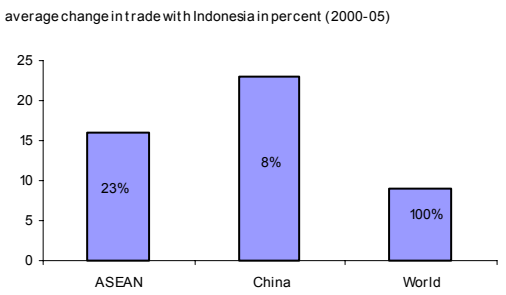
ASEAN trade with China increased significantly. ASEAN imports from China grew by an average of 25 percent over 2000-04, reaching $39 billion in 2004. Similarly, ASEAN exports to China grew by 27 percent over 2000-04, reaching $35 billion in 2004. Much of the increase in this bilateral trade took place in 2003, when ASEAN imports from China jumped by 57 percent and ASEAN exports to China by 74 percent. This increase continued in 2004, albeit at a slower pace. While the ASEAN-China FTA started implementation of its Early Harvest Program in 2002, many of these preferences initially applied to agriculture products. The increase in bilateral trade, however, was more due to the unprecedented growth of China and its increasing role as a hub for manufacturing processing.

In contrast to the trend of trade with China, ASEAN-Japan trade declined over the same period. ASEAN exports to Japan declined from 13 percent of its total exports in 2000 to 10 percent in 2004, and ASEAN imports from Japan declined from 20 percent in 2000 to just 16 percent in

2004. ASEAN-Korea trade continued to increase, although the share remained stable during the past 4 years.

Indonesia is trading more with ASEAN and China. During 2000-05, Indonesia's trade with ASEAN grew by 16 percent on average—with imports from ASEAN increasing by 25 percent and exports to ASEAN by almost 9 percent. Indonesia's trade with China grew even more—by 23 percent on average, with imports increasing by 25 percent and exports by 21 percent. For Indonesia, both ASEAN and China became relatively more important trading partners as the share of Indonesia's trade with ASEAN increased from 18 percent in 2000 to 23 percent in 2005 and the share of Indonesian trade with China also increased from only 5 percent in 2000 to 8 percent in 2005 (Figure 2).

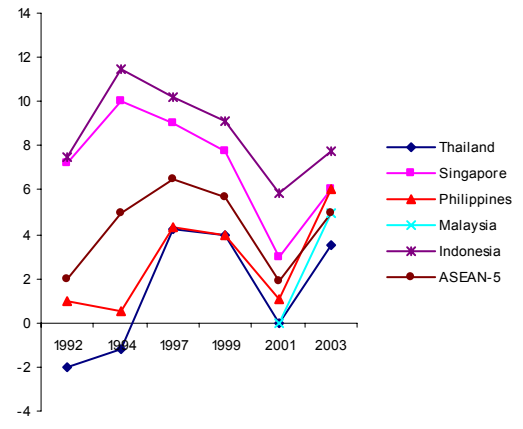
Figure 2: Indonesian Trade with ASEAN and China (2000-2005)



Note: the number in the columns represents the percent share in Indonesia's world trade
Source: UN-COMTRADE

Intra-ASEAN trade increased less than expected after AFTA was initiated. There are several factors attributed to the relatively low intra-regional trade in ASEAN. First, the AFTA margin of preference was low as a result of a rapid unilateral tariff reduction. The margin of preference of ASEAN CEPT decreased overtime, except in 2003 when it began to increase again due to the ASEAN implementation of CEPT 0-5 percent maximum tariff (Figure 3). Second, ASEAN exports are very similar (see James, 2005). Third, the emergence of China as a major powerhouse in the region may have diverted some trade away from ASEAN into China.

Figure 3: Margin of Preference Amongst ASEAN-5, 1992-2003



Source: reproduced from Damuri et al. (2006)

Case Studies: Electronics, Textile and Apparels, and Automotive

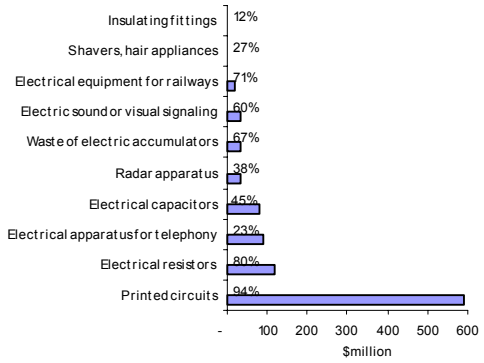
Electronics, apparels and textile, and automotive parts are among the 11 ASEAN priority sectors and are highly traded in the region. These three sectors accounted for about 42 percent of Indonesia's exports to ASEAN in 2005—19 percent in electronics (HS 85), 19 percent in auto and auto components, and 4 percent in textile and garments.

Electronics. Electronics is the most highly traded product in ASEAN, accounting for about 37 percent of total ASEAN trade. Intra-regional trade in electronics is characterized by high product specialization among member countries and high intra-industry trade. The relatively open trade regime among ASEAN member countries in electronics allowed this integration to deepen and provided incentive for MNCs to locate their production chains within the region.

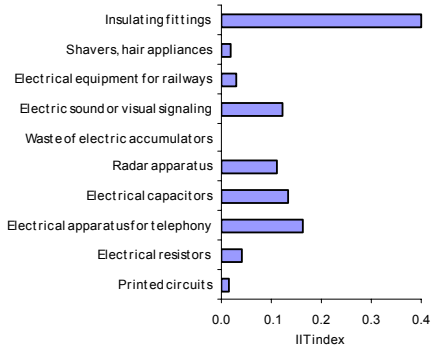
For Indonesia, the most traded electronics commodities within ASEAN, measured by the share of intra-ASEAN trade to world trade, are printed circuits (94 percent), electrical resistors (80 percent) and electrical signaling and safety equipments (71 percent). Exports of these three commodities to ASEAN grew rapidly (Figure 4). The intra-industry trade index is also high for several electronics products, reflecting the production sharing taking place between Indonesia and other ASEAN countries.

Figure 4: Top 10 Indonesian exports of electronics to ASEAN, 2005

Value ($million) and export share to world (in %)



Intra-industry trade index

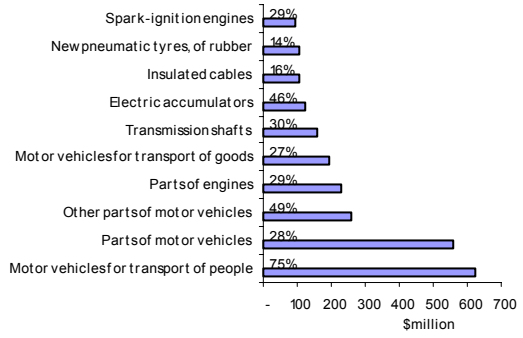


Source: UN-COMTRADE

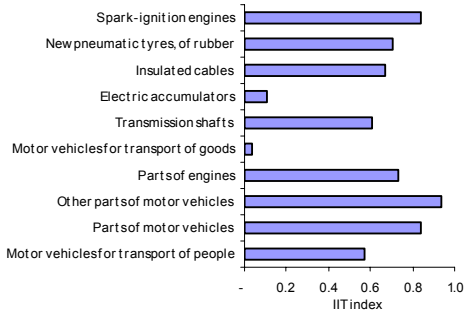
Auto and auto components. In auto and auto components, ASEAN is regarded as the production base and market for Japanese auto manufacturers. The principal manufacturer determines the production location of certain parts or cars within ASEAN, and exports them to the rest of the ASEAN countries for assembly or consumption. For Indonesia, the largest exports of auto products to ASEAN are motor cars and other motor vehicles (HS8703), and parts and accessories (HS 8708, 8714, 8409) (Figure 5). The intra-industry trade index for most automotive products is very high, reflecting both vertical intra-industry trade (where Indonesia trades parts and components for production) and horizontal intra-industry trade (where Indonesia trades final products of varied quality).

Figure 5: Top 10 Indonesian exports of automotive products to ASEAN, 2005

Value ($million) and export share to world (in %)



Intra-industry trade index



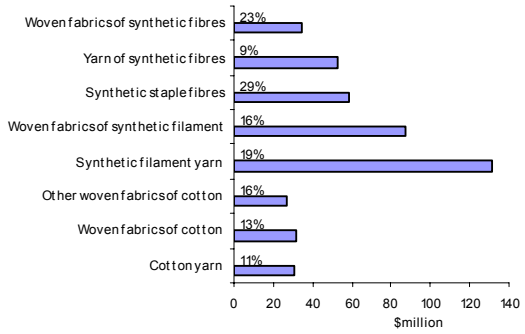
Source: UN-COMTRADE

Textile and Garments. The ASEAN region is home to many world class textiles and apparel companies, with end products (garments) exported to non-ASEAN countries. However, intra-ASEAN trade of textiles and garments is relatively low—at around 5 percent of total intra-

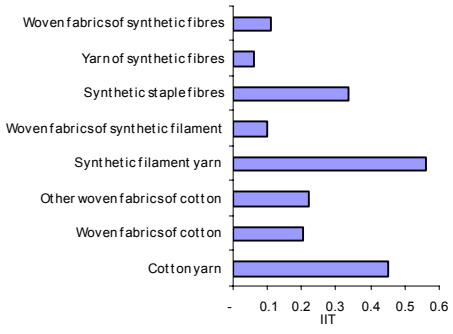
ASEAN trade. Intra-ASEAN trade is higher in the yarn and fabric category. For Indonesia, export of textiles and garments to ASEAN is also small compared to automotives or electronics, and it mainly consists of fabrics (Figure 6). Intra-industry trade for these commodities remains low, except for a few products such as cotton and synthetic yarn.

Figure 6: Top 10 Indonesian exports of textile and garments to ASEAN, 2005

Value ($million) and export share to world (in %)



Intra-industry trade index



Source: UN-COMTRADE

2 Preferential Regional Agreements and Rules of Origin

Indonesia is a member of APEC and ASEAN, including the ASEAN Free Trade Arrangement (AFTA) and the subsequent preferential trading arrangements coming out of ASEAN, such as ASEAN-China, ASEAN-Korea and ASEAN-Japan. Apart from those regional commitments, Indonesia did not engage in bilateral agreements until recently (Table 1). It has been negotiating an economic partnership with Japan since 2005. It is also currently considering a few bilateral trade agreements with major potential trading partners, such as the US, EFTA, South Africa and Australia.

Table 1: Indonesia's Regional and Bilateral FTAs

Trading Partner	Status	Notes
Regional		
APEC	Voluntary implementation	
ASEAN	Implementation complete	
ASEAN-China	Implementation covering trade in goods complete	Normal track: July 2005-July 2012 Trade in services and investment under negotiation
ASEAN-Korea	Recently signed	Normal track to be implemented in July 2006
ASEAN-India	Under negotiation	To cover trade in goods. Trade in services and investment not yet negotiated.
ASEAN-Australia and New Zealand	Under negotiation, beginning early 2005	Negotiation expected to be completed in two years
ASEAN-Japan	Under negotiation, beginning early 2005	Negotiation expected to be completed in two years
ASEAN-EU	Under consideration	
Bilateral		
Indonesia-Japan	Economic Partnership Agreement currently under negotiation	Negotiation began in June 2005. Coverage: goods, services, investment, natural persons, and cooperation. Both countries submitted requests and offers.
Indonesia-EFTA	EFTA has requested a bilateral FTA with Indonesia	Feasibility study carried out in 2005, but results are not out yet
Indonesia-South Africa	Under study by MOT	Feasibility study carried out in 2005, but results are not out yet

Source: MOT

AFTA rule of origin. Under AFTA CEPT, a product is considered to be originating from ASEAN if (1) it is wholly produced or obtained in the exporting member state; (2) at least 40 percent of its content originates from member states in cases where the product is not wholly obtained/produced in the exporting country; or (3) locally procured materials are produced by established licensed manufacturers, in compliance with domestic regulation.

The (indirect) formula for the value added rule is defined as:

$$\frac{\text{Value of imported non-ASEAN materials, parts or produce} + \text{Value of Undetermined Origin materials, parts or produce}}{\text{FOB Price}} \times 100\% \leq 60\%$$

The (direct) formula for value added rule is defined as:

$$\frac{\text{ASEAN raw material + labor cost + overhead + profit+ other cost}}{\text{FOB}} \times 100\ \% \geq 40\%$$

Member countries have the flexibility to use either the indirect method or the direct method to calculate the ASEAN content. However, once a particular method is adopted, changes can only be made if the AFTA council meeting is notified. Indonesia has adopted the direct method in determining the ASEAN content.

Following a request from member countries, a product-specific rule was later adopted as an alternative to value added for commodities which are part of the priority sector integration in ASEAN. These are:

- Aluminum and articles thereof (HS chapter 76): change of tariff classification at the 4-digit level
- Wood-based products (HS chapter 44, HS 94.01-94.03 and 94.06): change of tariff sub-heading (CTSH) at the 6-digit level with additional requirements that the products have not undergone a simple process, defined as trimming, cutting-to-size, sanding, attaching accessories article or overlying and/or coating.
- Wheat flour (HS1101): specific rule that the particular product needs to undergo milling from wheat grain prior to importation into another ASEAN country (i.e. a technical requirement), in addition to a change in chapter classification
- Textile and garments: in addition to the value added criteria, specific substantial transformation criteria also apply.

To be eligible for the preferential treatment, a certificate of origin must accompany the export documents. The certificate of origin is issued by designated bodies in the exporting member countries. ASEAN does not yet recognize self-certification by exporters.

ASEAN-China FTA. ASEAN and China agreed to establish the ACFTA in 2002. The ASEAN-China FTA began with the Early Harvest Program, which allows individual ASEAN member countries to enjoy tariff concessions earlier. The Early Harvest Program covered mainly agricultural products, although the list of products under the EHP differed across countries. The complete ASEAN-China agreement entered into force only in July 2005. In the ASEAN-China FTA, ASEAN also adopted a general value added rule and alternative rules similar to those of the AFTA CEPT. However, product-specific rules of origin for different products are being negotiated in addition.

ASEAN Integration System of Preferences. Within ASEAN, the founding members of ASEAN are required to give tariff concessions to the new members on a non-reciprocal basis, called AISP. The product coverage of each AISP differs across preference granting countries as well as recipient countries. As the database of AISP is not as well established as AFTA CEPT, margins of preference of AISP are difficult to obtain.

Table 2: The ASEAN Integration System of Preferences (as of September 2004) – Number of tariff lines covered

Preference Receiving Country	**Preference Granting Country**				
	Brunei (0% tariff)	Indonesia (0-5% tariff)	Malaysia (0% tariff)	Philippines (0% tariff)	Thailand (0-5% tariff)
Cambodia	8	41	89		309
Lao, PDR	14	23	12		187
Myanmar	79	294	282	67	460
Vietnam	1	82	170	10	34
Total	102	440	553	79	990

Note: Singapore has 0 tariffs; Brunei has yet to issue the AISP legal enactment.
Source: ASEAN Finance and Macroeconomic Surveillance Unit Database.

Indonesia-Japan Bilateral Free Trade Agreement. The free trade agreement between Indonesia and Japan is still under negotiation. Negotiations began in July 2005 and are expected to conclude early 2007. Regarding the ROO for goods, the Japan-Indonesia BTA may be moving towards the adoption of a product specific rule (line-by-line approach). This is because the Japanese have already adopted a similar approach under the Japan-Malaysia EPA.

3 Utilization of Form D under AFTA CEPT

The AFTA CEPT rule of origin, which was originally the ASEAN-PTA rule of origin, has been applied for several years. Indonesia uses the direct method in calculating the ASEAN cumulative content where ASEAN raw materials plus production cost and profit can be added to reach the 40 percent ASEAN content rule.

A survey was conducted to gauge the issues exporters may experience with obtaining preferential status. A total of eight firms were included in the survey, mainly medium and large. In the auto sector, interviews included one auto maker, two parts producers, and one trader. In the processed food sector, interviews included one edible oil producer and one fisheries products producer. Two furniture companies were interviewed in the wood products sector. In addition, interviews were undertaken with resource persons in small scale exporting firms regarding the trade impediments they face.

New exporters and SMEs still experience difficulties with filling out Form D. The firm-level survey shows that the 40 percent value added is a simple rule, but its implementation is not always simple. While the majority of established exporters interviewed found no difficulties in filling in Form D, it did take them some time to become familiar with it when it was first introduced. Even officials who issue the certificate of origin initially found the procedure complicated. Today, it is mainly new exporters that need assistance filling in the documentation and applying the method of calculating the ASEAN content. This is especially the case for SMEs, as the value added formula requires an accountant to calculate the ASEAN content method which SMEs might not have resources for.

Indonesia's utilization rate of ASEAN CEPT is low. Exports using Form D were about $0.4 billion in 2003, implying a utilization rate as low as 4 percent, slightly lower than in 2002 (Table 3). The main reason for the low utilization of Form D are the low MFN tariffs across ASEAN countries. The majority of Indonesian exports to ASEAN face MFN rates less than 5 percent—100 percent of exports to Singapore, 82 percent of exports to Malaysia, and 75 percent of exports to Thailand and the Philippines. Consequently, only a limited amount of exports require Form D.

Table 3: Utilization of Form D in Indonesia

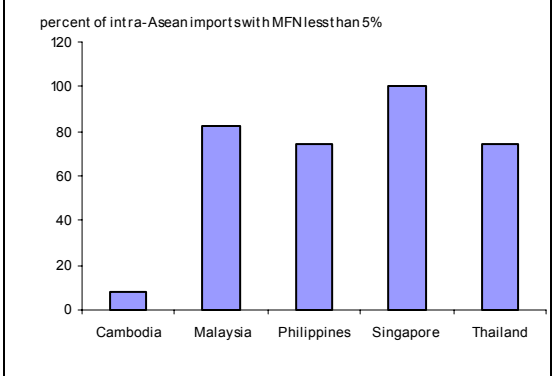
	2000	2001	2002	2003	2004	2005
Exports to ASEAN ($million)	10,469	9,419	9,765	10,656	12,523	15,394
Exports to China ($million)	2,419	2,037	2,552	3,330	4,433	5,786
CEPT Form D utilization rate (percent)	n.a.	n.a.	6	4	3	n.a.
ASEAN-China Form E utilization rate (percent)	n.a.	n.a.	n.a.	n.a.	2	n.a.

Source: MOT
Note: Data for CEPT utilization rate for 2004 cover the first 8 months only.

The Government of Indonesia requires that Form D be issued in one day, but in practice it takes longer. In Indonesia, Form D is issued by either the Regional Office of the Trade Department at the provincial, city/municipality level, or by the trade officer at bonded zones. Currently, there are about 43 institutions issuing Form D, including 3 bonded zones. In order to obtain the certificate of origin, exporters need to obtain/buy the form from the nearby trade office or bonded zones, fill it out, and return it to the same institution with additional documents including an export declaration form, a bill of lading, and the cost calculation. The field survey indicates that for established exporters, applying and filling out Form D is no longer problematic compared to the early stage of AFTA CEPT. The government of Indonesia requires the issuer of the certificate of origin to issue the signed form within 1 working day from receipt. However, some survey respondents complained that the issuance of Form D often takes longer than required by the regulation.

The institutional arrangement for issuing Form D is not strong enough. In Indonesia, where the direct method is used in determining the origin of the product, Form D can be issued in a relatively short time (typically one day), as the cost calculation is only checked once at the initial exportation. The survey found that although there is a sector-specific rule of origin within ASEAN CEPT, Indonesia applies only the 40 percent rule. This could be because relevant institutions in charge of issuing the certificate of origin lack knowledge about the rule of origin. The institutional set up for trade agreements and their implementation is partly responsible for such oversights. The free trade agreement, including the rule of origin, is agreed upon by the DG for International Cooperation of the Ministry of Trade at the central government level. The issuer of the certificate of origin, however, is mainly the regional office of the Ministry of Trade. The flow of information and the division of labor between the central and the regional offices seem uneven. For example, while software for administering the certificate of origin has been available for over a month, exporters dealing with regional offices have not used it yet.

Figure 7: Intra-ASEAN imports facing MFN tariff of less than 5%



Source: TRAINS database and author's calculations.

The survey also found that many exporters do not know about the preferences, especially new exporters. Those who know about the preferences are not able to get assistance from their respective business association on how to obtain the preferential treatment. Instead, they are referred back to the MOT for assistance, which sometimes discourages them to further pursue the matter due to the cost involved (in terms of time and financial resources).

Overall, firm surveys show that rules of origin are almost not relevant for Indonesia as most of its exports to ASEAN face a low MFN tariff which provides fewer incentives for exporters to use the preference (Figure 7).

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Chapter 7
Lao PDR

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1 Overall Economic Environment

Since the adoption of the "New Economic Mechanism" (NEM) in 1986, Laos has gradually been moving from a centrally-planned to a market-oriented economy. But it was not until 2000 that successful macro-economic stabilization reforms started and structural reforms were revived, including public expenditure management, banking, state-owned enterprises (SOEs), forestry, trade and private sector development. Since then, important steps have been taken towards creating a more conducive investment and business environment and a more open trade regime. These reforms have all contributed to the present economic growth of Laos—GDP growth reached 7% in 2005, up from 6.4% in 2004. This growth came largely from increased foreign investment flows in hydropower, mining and mineral exports. There is an increasing interest from investors in the region to invest in agriculture, agro-processing and manufacturing with the Government of Laos (GoL) approving projects worth $430 million for plantations of rubber, eucalyptus, palm and sugarcane. Agriculture accounts for 46% of GDP, industry and handicraft for 28%, and services for 26%.

2 Trade Liberalization

Laos has been integrating gradually into the region as well as the world economy. Laos applied for full membership to the World Trade Organization in 1997—the second Working Party took place in November 2006. Laos signed bilateral trade agreements with 19 countries and is granted GSP status in 35 countries. It became a member of the Association of South East Asian Nations (ASEAN) in July 1997 and joined ASEAN Free Trade Area (AFTA) in 1998. Under the AFTA agreement, Laos is committed to transfer 98% of the tariff lines to the Inclusion List (IL) and then reduce tariffs on IL products to 0-20% by 2005 and 0-5% by 2008 in order to reach the common effective preferential tariff (CEPT). As of January 2004, tariff rates have been reduced on nearly two thirds of the items in the IL. This represents a significant liberalization for Lao PDR as nearly 80 percent of its import comes from the region.

Laos's MFN import duties are low and not highly dispersed. The highest current import tariff rate is 40 percent (compared with about 150 percent in 1995) and for most products the tariff rate is below 15 percent. The unweighted average tariff is 9.5%, the weighted average tariff is 14.7%, and the median tariff is 5%. Low tariffs are levied on investment goods and inputs for industry, while higher tariffs apply to non-essential luxury goods. Preferential treatment is applied to investment goods under FDI (tariffs of 1%), while tariff exemptions are applied with regards to inputs for processing of exported goods. Yarn and textiles used for garment exports can be imported duty free.

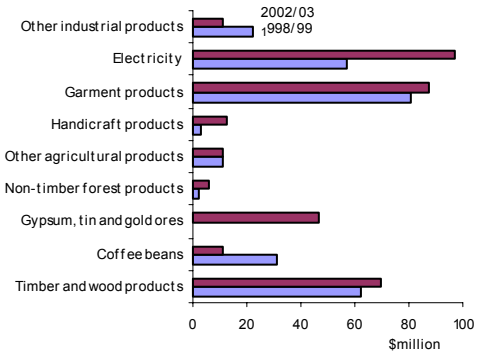
Simplified importing and exporting. Import restrictions still apply for a limited number of goods, such as fuel, construction materials (cement, steel), and some sensitive agricultural products. Pre-shipment inspection is not used. Turnover and excise taxes, in addition to import duties, are payable on imports. Exemptions are applied to goods that are imported for further transformation. As of October 2004, import and export licensing arrangements have been simplified. To export, companies need to present only an invoice and a packing list to the officials at the border checkpoint (one-stop service). To import each year, importers need to present an annual import

plan to the Trade Department and can import against this plan throughout the year. Traders in provinces along the borders, especially traders/exporters of agricultural products such as coffee and NTFP who do not have registered business licenses, can obtain a so called "temporary product collection" permit. This covers approximately 3 months for a given season. These exporters can bring goods through normal export procedure or can simply be intermediaries in the trade chain.

3 External Trade Performance

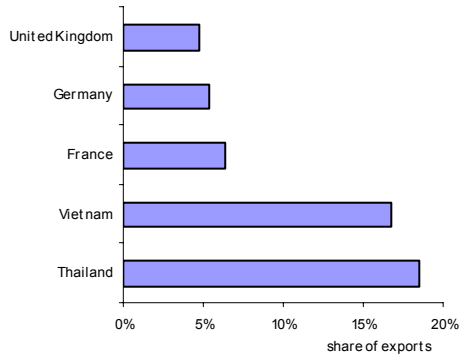
Highly concentrated export products to a concentrated market. Export has remained stable over the past 5 years. By 2005, the total export earnings grew to about $660 million or an increase of more than 30% compared to 2004. Lao exports are highly concentrated, with three product categories—garments, wood and wood products, and coffee—accounting for 96% of total exports of merchandise goods (electricity not included) (Figure 1). Lao export markets remain concentrated in a few countries: ASEAN (mainly Thailand and Vietnam) and the EU accounted for 80% of the total exports in 2000-03. Nearly 70% of official Lao exports of goods remain concentrated in wood products to Thailand and garments to the EU. Laos imports mainly from neighboring countries, including Thailand, China, and Vietnam. This makes the country quite vulnerable to external conditions due to its dependence on a limited market and thin industry.

Figure 1: Export trends in Laos



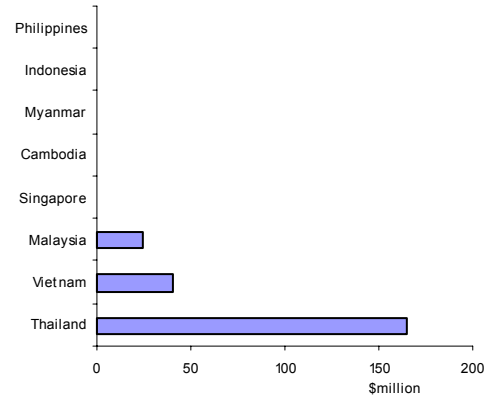
Source: Ministry of Commerce, Lao PDR

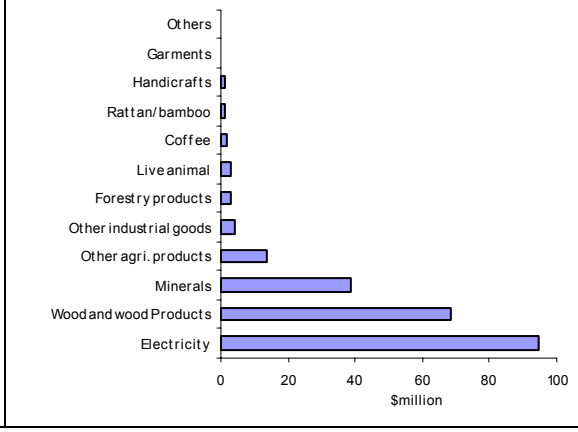
Figure 2: Principal export destinations, 2004



Source: IMF DOTS

Figure 3: Exports to ASEAN countries in 2004/05, by country and by product





Source: Ministry of Commerce, March 2006

Informal trade is considered "significant" for both unrecorded legal and illegal exports and imports. The amount of unrecorded exports may be up to around 20% of the total recorded exports from Lao PDR and unrecorded imports to 31% of the total recorded imports. Major products included in the unrecorded exports are agricultural products including fruits and vegetables (34%), forest products (26%), livestock (20%) and handicraft products (12%). Major products included in the unrecorded imports are various kinds of consumption goods such as food and beverages, household utensils, clothing, footwear and cosmetic products. Since the fiscal year 1999-2000, the Ministry of Commerce (MOC) has been providing estimates of imports of "smuggled" goods, which account for between 8% and 14% of total imports (including "smuggled" goods).

4 Market Access and Global Trends in Specific Sectors

i. Textiles:

Garment exports reached $134 million in 2003, accounting for about a third of total merchandise exports in Laos. About 56% of garment exports are woven and 44% are knits. Most garment exports (91%) go to the EU, and only 3% go to the US, 3% to Canada, 1.23% to Norway, 0.72% to Japan and 0.13% to Australia. The following 5 product types comprise 76% of total apparel exports:

6110 Jersey, pullovers, cardigans (knitted or crocheted)
6203 Men's suits, jackets, trousers and shorts
6204 Women's suits, jackets, dresses, skirts and shorts
6205 Men's shirts
6109 T-shirts, singlet and other vests, knitted or crocheted

There are approximately 57 listed garment manufacturing companies that employ about 21,000 workers (as of early 2005). There are also around 39 small factories that are subcontractors of the bigger companies. About 46% of the 57 factories are FDI, 19% are joint ventures, and 20% domestic and locally owned. These are subcontractors of parent companies mostly located in Thailand and Hong Kong that offer only cut-make or cut-make-trim (CMT) with almost no backward linkages to fabrics and accessories.

Production structure, support industries, institutional bottlenecks. Most of the garment export manufacturers are OEM (original equipment manufacturing). They rely on customers to provide designs, product specifications and materials supplies nomination. All fabric, accessories and packaging materials are imported, with the procurement done by their headquarters or customers—64% of the export value is made from imported materials. Locally, there are only 2 textile mills, 11 embroidery factories (with 50 machines and 893 embroidery heads), 8 printing factories with cut panel screen printing and heat transfer printing, 2 carton box factories, 3 plastic bag factories, 2 wet processing facilities and no thread, zipper, buttons, reinforcement tapes, and interlining manufacturers.

The movement of goods through Thailand between Laos and a third country is governed by a Transit Transport Agreement between the two governments (renewed annually). Goods transiting through Thailand must use Thai vehicles. Goods carried by Lao trucks are reloaded onto Thai trucks at the border and sent to the sea port in Thailand. The cost of transit service in Thailand is about $800 per 40 foot container. In addition, inadequate infrastructure, cumbersome customs procedures and corruption (tea money) at the border raise transport costs and increase delivery times for exporting.

Preferential market access for Laos in textiles. As a least developed country, Laos enjoys preferential tariff rebates for shipments that qualify under the EU GSP preferential market access schemes. Laos enjoys GSP benefits for exports to Canada, Australia, Japan, and South Korea, and recently obtained normal trade relations (NTR) status for market access to the USA. Laos receives preferences from the original members of ASEAN with Thailand and Malaysia recently granting privileges on 24 items.

Summary of market access arrangements:	
WTO	no
Country status	LLDC
Access to EU	GSP
Access to USA	MFN
Use of Cotonou	0
Use of AGOA	0
Regional Trade Pact	ASEAN
Source: Ministy of Commerce	

In late 1995, Laos had difficulties in complying with the EU rules of origin under the GSP. The subsequent suspension of the GSP resulted in 14 garment factories closing, 3,500 jobs being lost and a $62 million reduction in exports. In 1997, a GSP derogation was granted that permitted Laos to export to the EU with cumulation with ASEAN, SAARC and ACP countries and limited tariff quotas on each category of garments.

Since Laos is still not a member of the WTO, it is subject to US quota limitation for Category 340/640 i.e. Men's and boy's cotton and cotton/synthetic woven shirts. Despite the expiration of the Multi-Fiber Agreement (MFA), exports of Lao garments continue to rise. "This is a surprise as we thought that our exports would drop because we would not be able to compete on quantity" according to Lao Garment Industry Association President, Mr One-Sy Boutsivongsakd. "We are surviving as we have chosen the right market and adapted to changing trends."[1]

ii. Wood processing industry:

The wood processing industry is an important sector for the Lao economy, accounting for about 40% of its total exports and employing about 22,000 people. Approximately 2.5 million ha or 22% of the forestland is officially designated as production forest (for raw material supply) with an estimated capacity of 77.8 million cubic meters. Production forests are owned and managed by the Government. In 2000, the main destinations for wood were Thailand (76%), Japan, China and Taiwan.[2] In 2005, export of wood and wood products dropped by 13%.

There are 182 primary industry factories (sawmills, miniature sawmills, and plywood), and 1,269 secondary industry factories (furniture). The production capacity of the existing sawmills is about two times higher than the average annual log supply would allow. Up to 90% of the sawn wood is directly exported without further value addition, which limits the access of secondary industries to raw materials for processing. The export volume and value of wooden furniture and other value added secondary products are very low and have not been growing during the last years.

Production structure, support industries, institutional bottlenecks. The Prime Minister's decree on Annual Allowance Cut (AAC) sets the logging quota. The Ministry of Forestry and Agriculture (MAF) is in charge of allocating provincial logging quotas while the Provincial Agriculture and Forestry department issues licenses to individual companies each year. The allocation volume and the related "royalty fees" vary considerably from province to province. The suggested average Floor Price Royalty is $422/cubic meter. There is also a 're-forestation fee' of 3% and a development fee of 10%. The Timber Sale Committee of the Province chaired

[1] "Garment industry survives wave of free quotas", Vientiane Times, May 24, 2006.

[2] Exports to Vietnam were not included in the UNCOMTRADE database, but may account for 30% of exports of wood and wood products from Laos.

by the Vice Governor is responsible for implementing this policy. There is no forest concession system in place that regulates log prices according to international market value.

Timber and sawn wood are among the 9 categories of products that are prohibited from being exported according to the MoC's notification on prohibited goods for import and export, No. 284, March 2004.[3] The export of such goods needs approval from the MoC as well as the line sector ministry. Wood processing activities are categorized into three lists: List 1 for activities promoted for foreign investment; List 2 for activities open for foreign investment with some restrictions; and List 3 for activities closed to foreign investment (Table 1). ISIC 2020 – 2029 activities would fall under List 1 if "planted wood" is used (in which case the activities are promoted) or under List 3 if "natural forest wood" is used (in which case no licenses are issued).

Table 1: Priority and excluded products

List 1: Activities **promoted** for foreign investment	**List 2:** Activities **open** for foreign investment **with some restrictions**	**List 3:** Activities **closed** to foreign investment
2101 Pulp, paper and paper board	**2010** Saw milling and planing of wood	
	3610 Furniture (of any material)	
When based on raw material supply from ***planted forests***: **2021** Veneer sheets, plywood, laminated board, particle board, other panels and boards **2022** Builders' carpentry and joinery (doors, windows, panels, etc.) Flooring parquets (actually part of 2010) **2023** Wooden containers **2029** Other products of wood (tools, handles and bodies for brooms or brushes, boot and shoe lasts, clothes hangers, wooden cases, kitchenware of wood, coat and hat racks, etc.)		When based on raw material supply from ***natural forests***: **2021** Veneer sheets, plywood, laminated board, particle board, other panels and boards **2022** Builders' carpentry and joinery (doors, windows, panels, etc.) Flooring parquets (actually part of 2010) **2023** Wooden containers **2029** Other products of wood (tools, handles and bodies for brooms or brushes, boot and shoe lasts, clothes hangers, wooden cases, kitchenware of wood, coat and hat racks, etc.)

Source: Ministry of Commerce

iii. Agro-processing:

Annual exports of processed food amount to about $20 million, of which 75% consists of primary processed coffee. There is significant unrecorded trade in this sector, primarily with Thailand and Vietnam, which could amount to 20-30% of the officially recorded trade. Agro-processing contributes to 48% of GDP and provides livelihood to 80% of the population, with comparative advantage for products such as castor oil, jute fiber, coffee, wheat, non-timber forest products (NTFPs) agar and eagle wood.

Products which have potential for export include:

- Rice: high end boutique varieties of rice that combine the glutinous character with aromatic flavor.

[3] MoC's notification on prohibited goods for import and export, No. 284, March 2004.

- Animal feeds: May be viable and could substitute for imports from Thailand and be exported to China and Vietnam,
- Vegetable oil: There are limited quantities of crude oil that is being produced in Laos (only low yielding pressure extraction) based on locally grown groundnuts and soybeans which are exported to Thailand for refining and then re-imported. There are also some imports of refined palm oil from Malaysia in bulk that is bottled in Laos but is currently too small, 6,000 tons/year.
- Coffee: Some 20,000 tons of primary processed coffee (drying of cherries, hulling and grading) is currently exported per year from Laos. Secondary processing (roasting, mixing, etc) is currently not done.
- Fruits and vegetables: Exports of processed fruits and vegetables (canned bamboo shoots and mangoes, baby corn, rambutan in syrup) exist on a limited scale and will need good marketing if exported to EU.
- Meat (from beef): There is a growing demand for meat in China, Vietnam and Thailand with reachable urban markets but Government support will be needed in terms of improving the food law, improving facilities and providing more modern slaughtering and processing facilities.

iv. Cement manufacturing:

The first successful cement plant of Laos (Cement Plant I) was built under cooperation with the Chinese Government. Cement Plant I started operating in 1994 with a production capacity of 73,000 tons per year, completely relying on domestic raw materials (coal and limestone from VangVieng and gypsum from Savannakhet). The cement production runs under Chinese Technology and Chinese Quality Standards.

A second cement plan (Cement Plant II) was built under a joint venture contract with the Chinese and produces 2 types of cement: (i) Portland Type I: American Standard ASMTC – 150; (ii) Portland Type II: Chinese Standard GB 175-1999 (ISO679). After building Cement Plant II in 2002, domestic production increased more than fourfold—from 80,000 tons in 2000 to 332,000 tons in 2003. Production covers 40% of the consumption need in the country, with the rest being imported mainly from Thailand (80%), Vietnam and China. Cement is one of the products that remains in the Temporary Exclusion List and has a maximum tariff rate of 20%.

Lao cement is competitive enough due to the availability of raw materials, low labor cost, and relatively low cost of electric power, with both plants being situated strategically at the center of the country. However, the scale of production is small, sources of coal are limited, and competition in the region is fierce. The low quality of the Lao cement is reflected in its price: 640,000 kip/ton compared to 680,000 kip/ton (with 10% tax) for Thai cement.

5 Preferential Agreements and Rules of Origin

The AFTA agreement aims at reducing barriers on intra-ASEAN trade. Under AFTA, tariffs of the six original members of ASEAN were reduced to 0-5% by 2003. For Cambodia, Vietnam, Laos, and Myanmar this plan is to be completed by 2008. The granting of tariff- and other preferences is governed by specific rules of origin under the Common Effective Preferential Tariff (CEPT) scheme whereby a local content requirement of 40% needs to be satisfied for a country to receive concessions. The CEPT also requires member countries to eliminate quota restrictions and other non-tariff barriers.

As a least developed country, Laos receives preferential treatment from many countries. Regional agreements include: AFTA, ECS from old members of ASEAN, EHP from China, BTA with Vietnam, and the Bangkok Agreement. Laos recently received NTR from the US which allows it to export using MFN rates (rather than higher than MFN rates). Laos receives GSP from most developed countries (Australia, Belarus, Bulgaria, Canada, EU-25, Japan, Norway, Russia, Switzerland and Turkey) but not yet from the US.

The Rule of Origin Division under the Foreign Trade Department (FTD), Ministry of Commerce (MOC) is responsible for the issuance of the Certificate of Origin (CO) for non-wholly obtained products or for priority products for export. Specific to each country, there are different forms used:

Form A for EU,
Form D for ASEAN,
Form AISP for Thailand and Malaysia,
Form E for China,
Form S for Vietnam,
CO for Korea

The Lao National Chamber of Commerce (LNCCI) provides and approves the Ordinary Certificate of Origin (CO) for wholly obtained products or non-priority products with no taxes imposed on them, whereby the importing country simply requires that the exporting country states the origin of the product.

Specific rules of origin provisions. Based on the rules, a manufacturer who needs the CEPT Form D must submit a Cost Statement for the product to the issuing authority at least 1 week before shipment. This document contains information about the factory and details of raw materials, both local and imported from ASEAN and non-ASEAN countries. The value of these materials must be CIF. The formula for the calculation of the 40% ASEAN content is as follow:

$$\text{1. For single Country content} = \frac{\text{Local material cost + Direct Labor and Direct overhead + Profit}}{\text{FOB price}} \times 100 \geq 40\%$$

$$\text{2. ASEAN Cumulative content} = \frac{\text{Local and ASEAN material cost + Direct Labor and Direct overhead + Profit}}{\text{FOB price}} \times 100 \geq 40\%$$

According to Rule 7 of the CEPT Rules of Origin, Form D of Laos is printed on ISO A4 paper, comprising one original in light violet and three (3) carbon copies (Duplicate, Triplicate, Quadruplicate) in orange. Each CEPT Form D bears a separate reference number. The normal processing of CO takes 3 days and is free but it could be accelerated at a price: within 1 hour (50,000 Kip or $5); submit in the morning and get it back in the afternoon (40,000 Kip or $4); or get it back the following day (30,000 Kip or $3).

Other preferential schemes

- The **ASEAN Integration System of Preferences (AISP)** offers preferential tariffs to newer members in about 1,117 tariff lines.

- **Australia** allows entry of goods manufactured in least developed countries free of import duty for 2 categories of goods: raw products and manufactured goods. Goods qualify as the manufacture of a least developed country if: the last process was performed in the least developed country and the allowable factory cost of the goods is not less than 50% of the total factory cost of the goods. Sufficient evidence is required by obtaining a declaration from the manufacturer.
- The **Bangkok Agreement** allows preferential access to member countries of the Asia-Pacific Trade agreement such as India, Korea and Sri Lanka.
- In **Canada,** importers must have a proof of origin at the time a product is imported. The exporter in the country where the goods were finished must issue Form A or an Exporter's Statement of Origin. For textiles and apparel products exporters need to present proof that they have been manufactured using inputs from any of the 48 eligible least developed countries, provided the value added is at least 25%. Form B255 must be used.
- The **EU** GSP scheme (Everything But Arms – EBA) allows duty-free and quota-free export to the EU of all products from least developed countries with the exception of arms and munitions. Form A is issued by the EU-recognized competent governmental authorities of the exporting country (usually ministerial bodies) if they determine that the exports meet the requirements of the rules of origin.

  The EU-Laos Agreement on Trade in Textile Products further boosted the access of Lao textiles to the EU single market. Products covered by the agreement require a specific certificate of origin, which must always be certified by the Lao competent authorities with a declaration by the exporter on the invoice or another commercial document stating that the products originate in the Lao People's Democratic Republic.

  A further and permanent relaxation of the Preferential Rules of Origin was introduced in January 1999 when the EU granted the Regional Cumulation advantage. This advantage—reserved for members of regional groupings such as ASEAN—allows Laos to consider intermediary inputs, such as fabric, imported from another ASEAN country as having been produced in Laos.[4]
- The **Japan** GSP scheme is used by the Lao People's Democratic Republic to export handicrafts, natural mushrooms, textiles and wood products.
- The Government of the **United States** launched the GSP in 1976 and it now offers duty-free treatment for more than 4,650 products from 144 designated countries and territories throughout the world.

The challenge is to get individuals and enterprises to make use of the AFTA preferential tariffs given that 80% of Laos' external trade is with ASEAN countries. Currently no precise data is available on the frequency of CO usage. Based on interviews with the Foreign Trade Department, 5-6 companies apply daily and the Department releases 20-30 certificates a day. A CO is released for every shipment that is made. Further information provided by the GSP Department on a sample report of the number of COs availed of during one week shows that most CO forms are

[4] Initially Laos did not request a derogation on ROO under Article 76. According to Article 67 of EU Regulation 2454/93, all garments made from imported fabrics could not claim GSP status. As a result, 14 garment factories in Laos closed, 3,500 jobs were lost, and exports were reduced to $62 million. In September 1997, GSP derogation was granted by the EU that permitted Lao garment companies to export garments that were either based on ASEAN fabrics or on those from SAARC and the ACP countries with limited tariff quotas on each category of fabrics. In January 1999, the EU agreed that Laos could use the ASEAN Cumulative GSP rules (Article 72a, EU Regulations 2454/93) with quotas free access to the EU markets.

used for export of garment to EU countries (Table 2). Box 1 summarizes the Weekly Report of the GSP department.

Table 2: Number of forms sent out during the week 12/07/06 to 18/07/06

Form Name	Number of Forms	Export Value	Product Type	HS Code	Country of Destination
AT	81	$2,597,336	T-Shirt, long sleeve, Kids' pants, Polo Men's shirt Men's sweat,	6105,6109, 6203 6111 6110,6205	France, UK Netherlands, Germany,
A	6	$65,309	1. Pradu 2. Towel 3. Men's chino 4. Beer Lao	4409 6203 2203	Japan Norway
USA	4	$41,260	Boys' T-Shirt, Men's Shirt	6110,6110	USA
Canada	1	$30,207	Men's Trouser	6203	Canada
AISP	1	$5,250	Beer Lao	2203	Thailand
D	0	0	0	0	0
S	2	$19,475	Chip Board Box fan	4410 8414	Vietnam
SPT	0	0	0	0	0
CO Korea	0	0	0	0	0
Total	***95***	***$2,758,837***			

Source: GSP Department, Ministry of Commerce

Box 1: Sample weekly report of the GSP Department for the week of 12-18/7/2006

- Issued 95 countries' Certificates of Origin within this week, with export value amounting to $2.8 million. The export value is slightly lower than last week's amount of $3.3 million. This is because there were no export items for the following: Form D, Form SPT and Form CO Korea. There were only two sets that were exported to Vietnam and one set of AISP item exported to Thailand.
- Summed up income statements such as fees, forms and urgent service fees regarding reference numbers and date of each bill from 10/2004 to 6/2006.
- Answered questions from EU customs officials about attached invoices and amount of packages which were not the same as the actual products sent by companies. It included four incorrect sets of documents from 16 sets in Form A.
- Translated the agreement document from the Ministry of Commerce and Vietnam to abandon the list of companies allowed to export to Vietnam with 0% of export tax; drafted an announcement letter about the agreement to the Commerce Division in Vientiane Capital and provinces.
- Advised Sommai Trading Company which requested a country of origin's certificate (Form S) in order to export fruits to Vietnam.
- Regularly received and checked application forms.

Source: GSP Department, Ministry of Commerce

The Certificate of Origin Division of the Foreign Trade Department of the MOC keeps records on the usage of Form D by both exporters and importers which show that their usage rate has not exceeded 0.1% of AFTA imports, which is much lower than utilization rates by LDCs of various preferences (Table 3). Although the problem of low usage of AFTA preferences is not unique, it appears more extreme in Laos. The main factor behind the low usage of preferences in Laos seems to be due to the procedures necessary to prove ASEAN origin where exporters must obtain 4 copies of the CO.

In general, Lao companies can comply with the ASEAN ROO but there are issues that should be addressed. Issues include problems with the calculation of value addition, difficulty in checking the actual price on the invoice, difficulty in complying with the requirements as Laos lacks the supply of raw material to produce the required local content. A study by JETRO[5] raises the following constraints to complying with the ASEAN rules of origin: weak supporting industries (and therefore difficulty in meeting local content requirement), cumbersome documentation procedures for acquiring Form D, difficulty in obtaining Form D when the listed HS codes do not match the import country code (though at present the newly introduced ASEAN Harmonized Tariff Nomenclature or AHTN comprises 8 digits: the 6 digits of the HS code used worldwide and the 2 digits of ASEAN's own unique classifications), and problems in interpreting the tariff code numbers.

Table 3: Indicators of trade preference schemes, 2001

		GSP Imports (Values $ million)		
Scheme	**Product**	**Covered**	**Received**	**Utilization**
US AGOA	Textiles and articles	1,047	375	35.8%
EU ACP	Textiles and articles	292	252	86.2%
EU GSP		3,186	1,447	45.4%
EU EBA 2002		3,424	1,847	54.0%
Japan GSP		47.5	25.2	53.1%
Canada GSP		3.3	2.5	75.1%

Note: all data is for "effective LDC beneficiaries" meaning that trade data is used only from those actively taking advantage of the GSP programs.
Source: Compiled from UNCTAD 2003, ADB Report

Box 2: The challenge of using Form D-AISP

"Lao Challenge", one of the wood exporters, decided to use the AISP form to get a better treatment instead of the usual Form D that it has been using to export to Thailand. But the Thai Customs refused to accept the form stating that they are not aware of the list under AISP coming from Laos. The goods were hence sent back. As a solution, "Lao Challenge" went back to using Form D and was advised by the GSP Department to carry along the list as allowed by Thailand under the AISP.

A further issue regarding the use of Form D was Vietnam's requirement to have the list of companies that are exporting from Laos and that would be allowed to export at zero tariff under the AISP. As a result of recent negotiations, Vietnam has dropped this requirement. There were also cases where exports were rejected because ports and borders were not properly informed of new rules or lists.

Source: Based on the interview with Ms Songkarn, Head of the GSP Department

6 Survey Results—Summary Statements from Respondents

A technical survey was conducted among selected manufacturing firms in Laos. Interviews were also conducted among key Government agencies and private forwarding and shipping companies. The survey included 5 main manufacturing sectors: (1) wood processing, (2) garment manufacturing, (3) agro-food processing, (4) motorbike (transport) assembly manufacturing and (5) cement, steel and electronics manufacturing. Due to the low export-oriented nature of the manufacturing sector in Laos, the study included companies that produce not only for export but also for local consumption; and not only exporting to ASEAN countries but also to non-ASEAN countries. The fieldwork was concentrated in Vientiane Capital where most of the key export

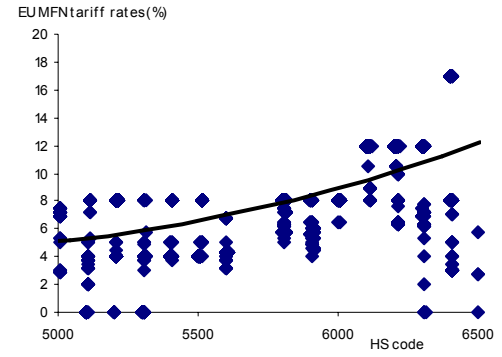
[5] ASEAN's FTAs and Rules of Origin, JETRO research Dept, Nov. 2004.

goods are manufactured. A total of 20 companies responded from among 50 companies that were contacted.

Responses indicate that Lao exporters seem to have some problems in complying with the Rules of Origin when exporting to ASEAN and other countries. Laos' main export destination is ASEAN (Thailand and Vietnam) where resource-based goods such a wood, minerals and hydropower are exported. Processed goods—such as garments, textiles and apparels—are exported to other countries, mainly the EU, and benefit from substantial preferences given to least developed countries. The tariff preference given to Laos is often around 10 percentage points compared to its competitors who have to pay MFN rates (Figure 4).

Though in general Lao exporters are able to comply with the Rules of Origin, issues include problems in the calculation of value addition, difficulty in checking the actual price in the invoice, difficulty in complying with multiple requirements from different countries, and the lack of available supply of raw materials and inputs in Laos to produce the required local content.

Figure 4: EU MFN tariff rates in textiles and garments, compared to zero tariff rates for LDCs



Source: Based on TRAINS

Low usage of Form D. Records of Form D by both exporters and importers from the Certificate of Origin Division of the Foreign Trade Dept of the Ministry of Commerce show that their usage rate has not exceeded 0.1% of AFTA imports. The problem of low usage of AFTA preferences is not unique but more extreme in Laos. The low usage of preferences is due to several factors. First, the procedures necessary to prove ASEAN origin are complicated, as exporters must obtain 4 copies of the CO. Second, the MFN rates in ASEAN countries are already low, and therefore the margin of benefit from preferences is low as well and does not always justify the cost of going through the complicated procedures of obtaining a CO. Third, the lack of local raw materials in Laos makes it difficult for firms to comply with the local content requirement. The 40% value added is not easily applicable in Laos for some products. Laos had proposed a 20% value added for the underdeveloped countries of ASEAN, but this proposal was not accepted, especially by Thailand.

Miscalculation in the application of ROO. There is further a problem of incorrectly filling the form and wrongly calculating value addition, especially for companies that often change the person who is in charge of doing that. For Laos, it is sometimes difficult to check the actual price in the invoice where the price shown may not necessarily be the real one. Exporters often declare 80% of the price and claim back 100% of the tariff exemption.

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Chapter 8
Philippines

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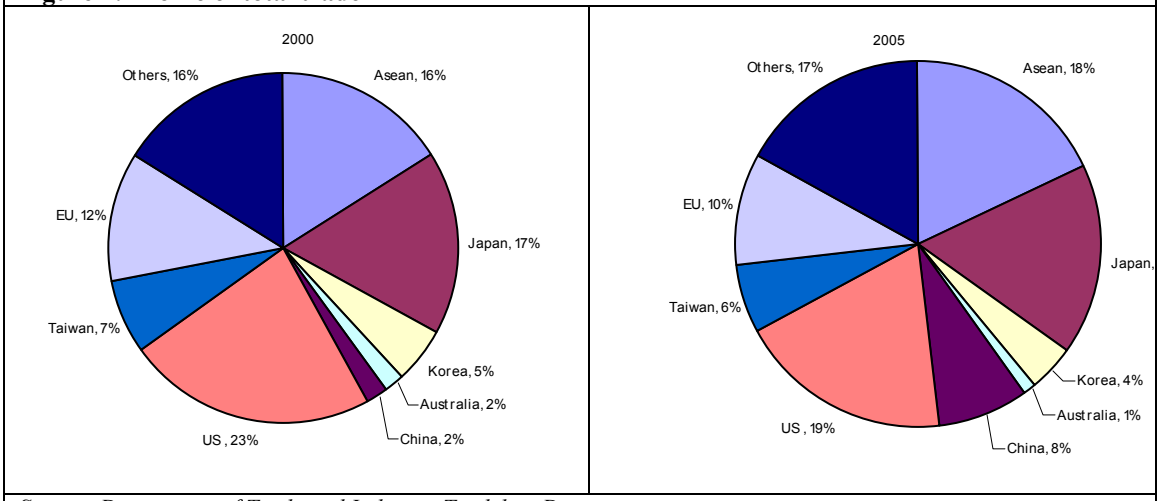
1 Export Profile

The Philippines trades more with developed countries than with developing countries. Close to 61% of exports went to developed country markets in 2000. In 2005, however, the share of developed countries shrank to 52% while the shares of Taiwan and China expanded. The changes partially reflect the changing supply chain and production sharing set up in the biggest export items of the Philippines—electronics. The sources of imports of the Philippines are more diversified. Only 46% of imports come from the developed countries in 2000 and this figure has decreased to only 41% in 2005. Developed countries accounted for 54% of total trade with the Philippines in 2000 (Figure 1). However, over a period of five years, trade with non-traditional partners such as China has increased to the extent that the share of developed countries in total Philippine trade has dropped to 47%.

Figure 1: Profile of total trade



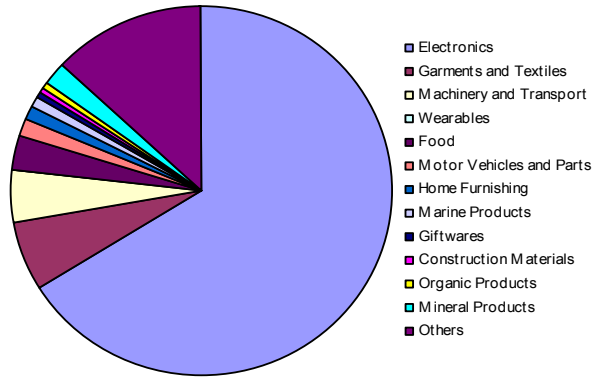
Source: Department of Trade and Industry, Tradeline Data

China's share has outpaced all other partners in the Philippines as an export destination. Philippine exports to China in 2005 have increased six fold since 2000 while its imports from China have increased threefold. Much of the growth in trade with China is fueled by electronics. With massive investments of multinationals over the past years, particularly in electronics, China has become a manufacturing hub. Intermediate goods that the Philippines manufactures are increasingly being shipped to China for further processing. At the same time other electronic intermediate goods that are manufactured in China are shipped to the Philippines for further processing and are eventually exported. The scale of the production volumes in the global supply chain of the electronics sector allows countries such as the Philippines and China to engage in intra-industry trade in many of the components that go into information technology products. Due to China's rapid economic growth over the past decade, its import demand from the rest of the world, the Philippines included, has increased. China is one of the countries where processed food exports from the Philippines have actually increased very sharply from 2000 levels.

Apart from China, the Philippines' exports to Australia registered more than a 40% rise since 2000. The Philippines' exports to Japan and ASEAN have also increased by more than 20% since 2000. Apart from China, the Philippines has begun to import more from ASEAN, the United States and Japan. In total trade, however, the Philippines has increased its trade with ASEAN (40% higher in value in 2005 compared with 2000) after China. Trade with the United States, traditionally the Philippines' biggest export market, dropped in 2005.

The Philippines' exports remain fairly concentrated. Electronics exports accounted for about 66 percent of the country's total exports in 2005, amounting to $27 billion (Figure 2). Much of this is semiconductors, which accounts for 48% of the country's exports or about $20 billion in value. Exports of clothing, apparel, and other wearables still ranked the second biggest export, accounting for more than 5 percent of Philippine exports in the same year and amounting to $2.2 billion. Agro-based exports and processed food accounted for 6 percent of exports; machinery and transport for 4%; and forest and mineral products for 2 percent. These are the Philippines' top five export categories, representing 84 percent of total exports.

Figure 2: Composition of Philippines' exports, 2005



Source: Department of Trade and Industry, Tradeline Data

2 Preferential Agreements

The Philippines has entered into an FTA with the ASEAN, through the CEPT-AFTA scheme, and is also party to the ASEAN-China FTA. The Philippine government is also currently negotiating with Japan to establish an economic partnership agreement, which would include the creation of a free trade area. Negotiations that began in 2004 have yet to be finalized.

As a member of AFTA, the Philippines follows the ROO which are used to determine the eligibility of the product to avail of the CEPT rates by identifying the products' origin.[1] Under the AFTA ROO, a product shall be deemed originating from a member state if it is "wholly obtained" or at the least 40% of its content originates from any member state. [2] It follows therefore that the contents of a product originating from non-ASEAN countries or of undetermined origin must not exceed 60% of the FOB value of the final product produced.[3] Locally-procured materials produced by established *licensed manufacturers* will be deemed to have fulfilled the CEPT origin requirement.

To what extent has the AFTA-CEPT fostered trade with the ASEAN? Between 2000 and 2005, trade of the Philippines with ASEAN rose by 40% but trade with non-ASEAN partners rose even faster. The share of ASEAN in the Philippines' trade rose from 16% in 2000 to 18% in 2005.

[1] The ROO governing the ASEAN-China Free Trade Area (ACFTA) essentially follows the ASEAN ROO.
[2] The Bureau of Customs through its Export Coordination Division (ECD) is responsible for evaluating whether the export product is qualified for ASEAN CEPT treatment.
[3] The method of calculating local/ASEAN content is as set out in Annex A. The rules to determine cost of ASEAN origin and the guidelines for costing methodologies in ANNEX B shall also be closely adhered to.

The share of imports from ASEAN increased by 3%, while the share of ASEAN as an export destination increased by only 1%.

The relatively stagnant share of ASEAN countries in the total trade of the Philippines conceals changes of commodity composition. In processed foods alone, the share of ASEAN as an export destination of the Philippines doubled in 2005 from 2000. At the same time, the Philippines is starting to import more processed food from ASEAN. Another sector that experienced more vigorous trade with ASEAN is transport equipment and parts—ASEAN accounted for 32% of exports and 37% of imports in 2005 compared to 26% and 13% respectively in 2000. Again, the introduction of international subcontracting networks by the multinationals that dominate the transport trade seems instrumental in fostering intra-ASEAN trade.

The role of the AFTA-CEPT in deepening intra-ASEAN trade can be gauged by the utilization rate of preferences under the trading agreement. The Philippines availed itself of the AFTA preferences on just 14% of its exports and 19% of its imports. The Philippines tends to utilize the AFTA-CEPT arrangements in its exports particularly to Thailand, Indonesia, Laos and Vietnam. On the other hand, Indonesia, Malaysia and Thailand tend to use the preferences when they export to the Philippines (Table 1).

Table 1: Philippine CEPT-AFTA utilization in 2005 (value in US$)

Country	Philippines CEPT Utilization*		Philippines Trade with ASEAN**		CEPT Utilization Rate (%)	
	Exports	Imports	Exports	Imports	Exports	Imports
Brunei	0	0	9,398,666	939,903	-	-
Cambodia	0	0	7,695,329	1,541,355	-	-
Indonesia	189,418,026	367,247,565	476,465,905	1,092,889,476	39.75	33.60
Lao PDR	721,246	0	877,240	0	82.22	-
Malaysia	153,400,882	397,857,649	2,452,777,358	1,842,923,824	6.25	21.59
Myanmar	7,512	0	9,087,081	1,336,702	0.08	-
Singapore	12,809,058	190,699,498	2,706,923,126	3,864,577,703	0.47	4.93
Thailand	565,330,298	755,356,262	1,169,151,394	1,678,686,117	48.35	45.00
Vietnam	89,663,494	61,481,127	311,566,346	834,576,082	28.78	7.37
Total	**1,011,350,516**	**1,772,642,100**	**7,143,942,346**	**9,317,471,162**	**14.16**	**19.02**

*Source: *BITR/BOC; **NSO*

A significant share of exports and imports of the Philippines in 2005 that made use of CEPT preferences belongs to the vehicle or transport sector. The most important export items to Thailand, Malaysia, Indonesia and Vietnam from the Philippines are in the transport sector. The high share of the transport sector under the CEPT scheme suggests that the margin of preference may be high, in which case preferential tariffs can be an important source of cost savings. Another driver of such exports could arise from special preferential trading programs such as the ASEAN Industrial Cooperation Scheme (AICO) where joint manufacturing industrial activities among ASEAN based companies are promoted. As multinationals, such as Honda or Toyota, rationalize their regional production processes, they allocate the production of certain components in certain countries to reap the benefits of scale and simply avail themselves of CEPT arrangements for moving the parts across ASEAN boundaries.

The import items that the Philippines sources from ASEAN using the CEPT preferences are more diversified. From Malaysia, Indonesia, Vietnam, and Singapore the major import items are

agricultural based commodities and petrochemical products and their derivatives. The biggest import item making use of CEPT preferences comes from Thailand in the motor vehicle sector.

Electronics and garments, the top two export products of the Philippines are not traded in utilizing preferences in ASEAN trade. The export destinations of these two products are non-ASEAN. At the same time, the imported inputs of these two industries are not primarily sourced from ASEAN. In addition, there are institutional arrangements like the establishment of export processing zones that allow duty free imports of components and inputs.

Another factor that could explain the relatively low utilization rates is the margin of preference arising from the AFTA-CEPT. The margin preference—the difference of the MFN and CEPT rates—represents the benefits of joining a free trade area. In principle the greater the margin of preference, the higher are the gains in making use of the CEPT rates. In this context, ROO considerations become important. In many ASEAN economies, the average MFN tariff is one digit only with considerable variation on the agriculture and non-agricultural products (Table 2). The margin of preference of the Philippines is quite low compared with the other major AFTA members, as the average applied MFN rate has decreased considerably in the Philippines as a result of its unilateral liberalization in the recent past.

Table 2: Average MFN rates of ASEAN

	Average MFN Rates		
	All	Agriculture	Non-agriculture
Brunei (2003)	2.6	0.0	3.0
Cambodia (2003)	19.0	19.5	15.9
Indonesia(2002)	6.9	8.2	6.7
Laos (2001)	9.6	18.9	8.2
Malaysia (2003)	8.4	3.3	9.1
Philippines (2004)	6.3	9.5	5.8
Singapore	0.0	0.0	0.0
Thailand (2003)	15.4	29.6	13.3
Vietnam (2004)	16.8	24.5	15.7

Source: WTO

3 Case Studies

i. Electronics

The electronics sector is one of the most dynamic industries in the Philippines. In a span of twenty years, the share of this sector in total exports has grown from a mere 3% to 66% in 2005. For many years, electronics has been the top export earner for the Philippines and notwithstanding the Asian financial crisis and the cyclical downturns of the global electronic industry, has managed to increase exports by 17% over 1995-2005.

The massive inflow of investments, especially foreign direct investments, has a major role in explaining the success of the electronics exports. Investment into the electronics sector hit its peak in 1995 at close to $2.16 billion. Although investments slowed over 2002 and 2003 (average of $250 million per year), they recently picked up again reaching $776 million in 2005. The export-oriented electronics sector is dominated by multi-national corporations (MNCs) although there is a growing base of Philippine owned firms usually in components supply. Currently there

are 883 firms of which 72% are foreign owned. Almost a third of all electronic firms are Japanese owned. Most of these companies are located in export zones.

The bulk of the production activities within the broad electronics industry is engaged in the relatively labor intensive task of assembly of semiconductor and parts. Industry experts estimate that both the direct and indirect employment from the electronics industry is around 402,000 as of 2005. Further, for every one direct job created, seven are indirectly created in the allied and support industries (Villegas, 2005).

Within the value chain of the global electronics/semiconductor industry, the electronic industry in the Philippines specialized in the semiconductor assembly operations. The ready supply, quality and cost competitiveness regarding human resources is the main edge of the Philippines in attracting investments in this relatively labor intensive process. The Philippines has around 30,000-40,000 engineering and technical graduates every year, and the average compensation of a production operator range from US$6-7 a day. Of late however, the emergence of alternative investment sites like China that offer more competitive cost structures has put competitive pressure on the Philippines in attracting additional foreign investments.

The emergence of lower cost investment sites indicates the shifting nature of comparative advantage in assembly types of operations away from the Philippines (as well as other ASEAN countries). As such there is a felt need in the Philippine electronics industry to move away from the assembly operations in the supply chain of electronics towards higher value added operations such as testing.

Business Models: Implications for ROO. The world electronics industry operates a global supply chain where different productive capacities are distributed among country sites that offer the most competitive conditions. In general, the industry can broadly be classified according to the following sub-sectors:

Table 3: Composition of the electronics industry

Sub-sectors	**Sample products**
Semiconductor Components and Devices	Integrated Circuits, Diodes, Capacitors
Consumer Electronics	TV Sets, Recorders
Office Equipment	Photocopying machines
Control and Instrumentation	
Automotive Electronics	Wiring Harness, Anti skid brake systems
Electronic Data Processing	Personal computers, hard disk drives, CD ROM
Telecommunications	Cellular Phones, pagers
Communications and Radar	CB Transceivers
Medical and Industrial	Spiro Analyzers, Smoke detectors

Source: Villegas, 2005

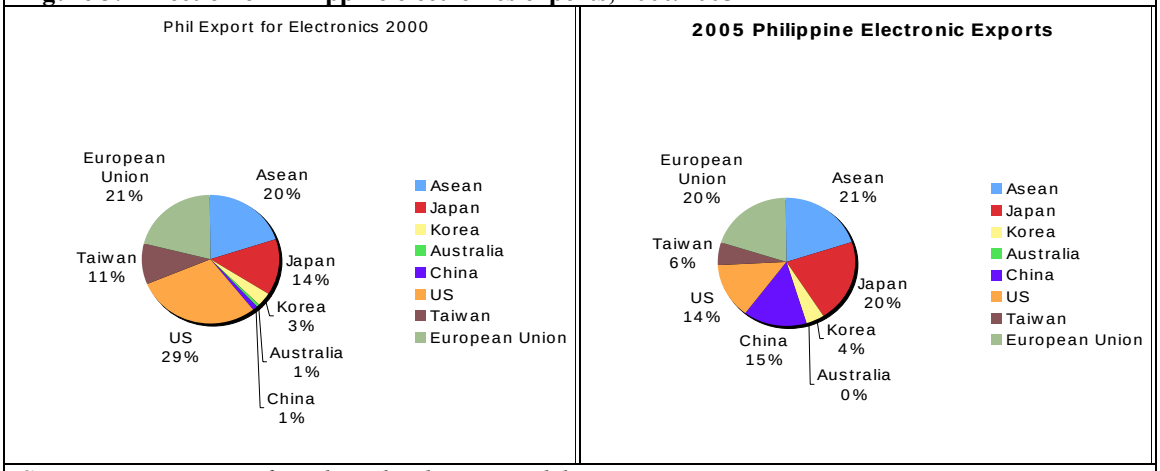
Each sub-sector has its own supply chain stretching across a number of countries. The impact of preferential rules of origin would depend on the particular sub-sector in the broad electronics industry. According to the Semiconductor and Electronics Industry of the Philippines, (SEIPI), over 74% of exports of the Philippines are semiconductor components and devices (SMS), while the rest of the sub-sectors, called EMS, account for the rest. Among EMS group, the computer products, notably hard disk drives, account for the largest share in exports.

In general, rules of origin do not appear to be a critical issue for the export-oriented electronics industry of the Philippines due to the following considerations.

First, from the global supply chain characteristics of the electronics industry of the Philippines, the bulk of trade of electronics involve non-ASEAN countries. The main outputs of the Philippines-based electronic firms are intermediate inputs to be used in later stages of processing of multinationals in other countries which exhibit comparative advantage in those activities. The decisions by MNCs to locate intermediate production processes that use ASEAN inputs in non-ASEAN countries are commercially driven. The fact that multinationals locate production facilities in non-ASEAN sites despite the presence of preferential tariff treatment, suggests that the economic benefits outweigh the savings on tariff duties under AFTA. Preferential ROO are therefore not very relevant for the electronics sub-sector.

By and large the main export destinations of Philippine electronic products are the developed countries (Figure 3). The share of the ASEAN countries did not increase substantially over the period 2000-05. The share of China as an export destination of the intermediate products expanded rapidly over the same five-year period while the share of the United States contracted. The changes could reflect the massive expansion of the electronic productive capacity of China due to foreign direct investments.

Figure 3: Direction of Philippine electronics exports, 2000/2005



Source: Department of Trade and Industry, Tradeline Data

The profile of imports of electronic products suggests that the bulk of inputs are sourced from mainly developed countries and the newly industrialized countries of East Asia. The pattern of imports conforms broadly with the industries in which developed countries have comparative advantage – technology-intensive and capital intensive wafer fabrication plants that constitute the inputs to the assembly-type semiconductor operations in the Philippines. The imports from ASEAN have actually decreased over the period despite the availability of preferential tariff arrangements. China is increasingly becoming an important supplier of electronics products.

Second, the difference between the MFN and AFTA-CEPT tariffs is very small. Not only are the margins of preference of the electronic products very small, but most of the tariff lines are actually at zero duty already. Most of the products in the electronics sector fall within the scope of the Information Technology Agreement (ITA) – a sectoral liberalization initiative under the WTO that paved the way for the drastic reduction of tariffs of information technology products in the late 1990s. This is especially true for the components and parts that make up computer systems which constitute the bulk of Philippine electronic production. Computer systems as well as most of the parts and components that go into the final product are subject to zero duty in the Philippines (Table 4).

Table 4: Margins of preference for selected electronics products

Item	HS	MFN (%)	AFTA CEPT (%)
Disk Drives, Plug-In ROM	8473.3000	0	0
Recorded Computer Media (CD ROM)	8524.3910, 8424.9910	0	0
Central Process Units	8471.5000	0	0
Magnetic or Optimal Readers and Other Computer Peripherals	8471.9000	0	0
Input/Output Units (Monitors, Scanners, Mouse, etc)	8471.6000	0	0

Source: Tariff Commission

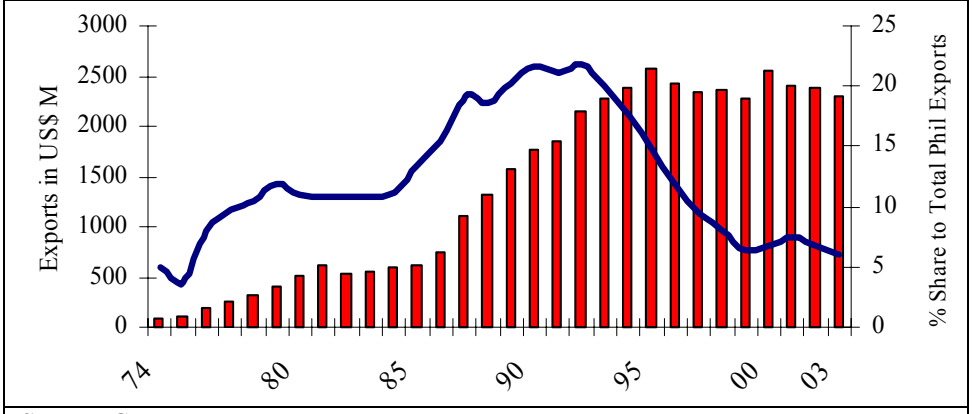
Third, a good portion of electronic firms in the Philippines operates out of export processing zones where they enjoy certain fiscal incentives including duty free imports of raw materials and capital equipment. Electronic exports from these zones account for around 50% of total exports. Multinational firms, dominated by Japanese, make up some 85% of these exports.

ii. Garments and textiles

The Philippine garment and textile industry is a major export sector of the Philippine economy, accounting for some $2.23 billion dollars in export earnings in 2005. Over the years, garments and textiles have consistently been one of the top five exports of the Philippines. However, export revenues from garments have been diminishing and currently stand at 5.4% of total Philippine exports, a significant decrease from a share of 20-23% in 1993-95 (Figure 4).

The slide of garment exports from the Philippines could be traced to at least three factors. First, the entry of more low-cost suppliers from South Asia, Eastern Europe and the regions which enjoyed preferential access to the US eroded preferences enjoyed by the Philippines in its most important garments market, the US. Second, the Philippines competitive advantage in garments production was overshadowed by the rise of other suppliers in terms of labor cost, logistics, turnaround time and reliability. Third, the quotas which restricted access to some competitive exporters were removed as the MFA was phased out in 2005.

Figure 4: Declining share of garments to total Philippine exports



Source: GTEB

Business Models: Implications on ROO. The general business model that characterizes the garments industry, particularly the international trading aspect, is the buyer-driven model (Antonio and Rodolfo, 2004). In the buyer-driven model, retailers (and those that manage brands) generally design and market but do not physically manufacture the branded products they order. These firms are essentially design and marketing firms without factories but whose physical production of goods are simply outsourced. In a typical set up the foreign buyers/ brand houses mainly come from the developed countries which deal with tiered networks of contractors from lower cost (i. e. developing) countries that carry out the physical production of the goods.

For the past decades, the activities of Philippine garment firms revolved mainly around the assembly stage of the production system. The Philippine garments industry is basically part of what is called triangle manufacturing (Gereffi, 2002), where a foreign buyer deals with an agent in a newly industrialized economy which then outsources production to third, lower cost countries such as the Philippines. The triangle is completed when the Philippine supplier of the outsourced order ships the products to the buyer. The competitive advantage of these firms in the Philippines used to be the lower cost of labor on the supply side, and the presence of the quota allocations from the United States and the European Union under the MFA on the demand side. However, due to the emergence of lower cost competitors in the region and the expiration of the MFA, foreign buyers have begun to divert export orders to the latter and away from the Philippine firms.

The preferential trading arrangement of the AFTA could potentially divert garment exports of the Philippines towards AFTA members and away from non-members and/or alter the choice of raw material sourcing in favor of AFTA countries. However, a number of institutional and structural features in Philippine garment trade erode the preferences in regional FTAs like the CEPT AFTA or the ASEAN-China FTA and with diminished benefits from preferences, the ROO that govern garment trade become less significant:

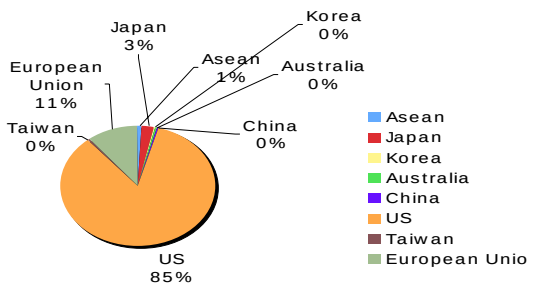
First, the export-oriented Philippine garment industry is made up of firms that do assembly subcontracting with the different foreign lead firms. Because the business model is the 'buyer-driven' one, the foreign lead firms specify the sourcing of the raw materials and in most cases directly supply or procure the inputs. Buyers nominate the fabric suppliers, mostly from China, India, and Hong Kong. Imports of fabric from the US and Italy are commonly used for the production of high-end products such as branded women's blazers. Other inputs such as accessories are also imported from China, Taiwan, South Korea and Hong Kong (Antonio and Rodolfo, 2004). In essence, the decision to source materials taking into account the economics of using the preferences by ordering from ASEAN suppliers does not lie within the decision making of the average Philippine garment firm that caters to exports. The fact that Philippine firms, particularly the majority that perform assembly type operations, simply have their inputs (mainly textiles) already consigned by the foreign buyer, suggests that preferential ROO under AFTA do not really matter to them. It may matter, however, to the foreign buyers.

Second, several arrangements provide for duty-free imports of raw material for export oriented industries, thus rendering preferential ROO rather moot in deciding where to source inputs. One of the most important privileges of locating in an export processing zone designated by the Philippine Economic Zone Authority (PEZA) is the exemption from duties and taxes on imported capital equipment, spare parts, supplies and raw materials. While the investments in PEZA zones are dominated by electronics, garments and textiles account for 2% of total investments over the period 1994-2004.

Moreover, Philippine exporters in the garment industry can avail themselves of a bonded warehouse system: BOI registered firms, can enjoy the advantage of having access to duty free importation of raw materials (textile/fabrics) through a bonded warehouse provided that they export 70% of their production. Given the superior cost savings that a bonded warehouse offers relative to the preferential tariff of the AFTA-CEPT or the ASEAN-China FTA, export oriented firms in the garments industry could in principle place their raw material imports into the bonded warehouse, even if they are coming from ASEAN. Again, to the extent that raw material imports for the garments industry enter the country duty free implies that the preferential ROO are not relevant from the point of view of favoring ASEAN suppliers in decisions on sourcing imported raw material.

Third, the bulk of Philippine garments exports go to developed countries such as the US, EU and Japan. Together these developed markets account for close to 99% of total garment exports of the Philippines. The ASEAN countries are not natural markets of Philippine garments because most of these countries, with the possible exception of Singapore and Brunei, are net exporters of garments with import-competing garments sectors. Thus, although the ASEAN CEPT would accord tariff concessions in the garments trade, at the moment there is relatively little trade in this sector between the Philippines and the ASEAN, in terms of finished goods (Figure 5).

Figure 5: Direction of Philippine garment exports, 2005



Source: Department of Trade and Industry, Tradeline Data

iii. Motor vehicle parts and components

The Philippine motor vehicle industry is comprised of two sectors: motor vehicle assembly and motor vehicle parts and components manufacturing. The motor vehicle assembly sector is grouped based on the type of motor vehicles, such as passenger cars, commercial vehicles (utility vehicles, pick-ups, vans, trucks, buses, special purpose vehicles) and motorcycles.

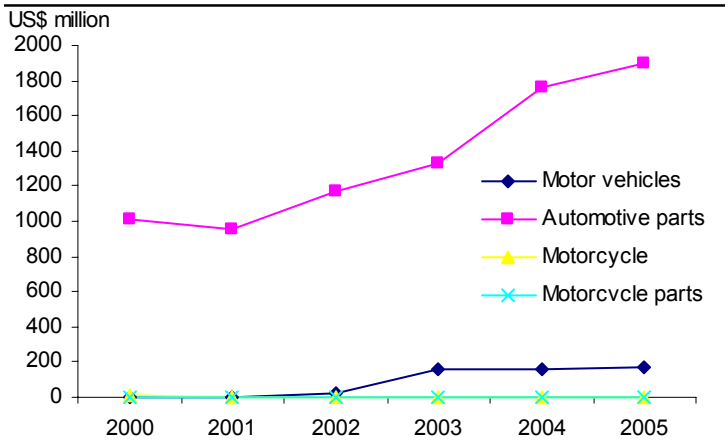
The Philippine motor vehicle industry is principally dominated by Japanese automobile manufacturers: Toyota Motor Phils., Inc., Honda Cars Phils., Inc., Mitsubishi Motors Phils., Corp., Nissan Motor Phils., Inc. and Honda Phils., Inc. Other principal motor vehicle manufacturers are Ford Motor Co. Phils.; Columbian Autocar Corp., Pilipinas Hino Inc. and Norkis Trading Company. The top markets for Philippine merchandise exports of motor vehicles are Japan, Thailand, Singapore, Vietnam, Republic of South Africa and Taiwan (ROC).

The parts and components manufacturing sector comprises of 256 companies producing various parts and components made of metals, plastic, rubber and composite materials for both the OEM and replacement markets. The principal components manufacturers are Yazaki-Torres Manufacturing Corp. (wiring harness), United Technologies Automotive Phils. (wiring harness), Temic Automotive (Phils.) Inc. (anti-brake lock system), Honda Engine Manufacturing Phils., Inc. (engines), Asian Transmission Corp. (automotive transmissions), Toyota Autoparts Phils. (automotive transmission), Fujitsu (car stereos) and Aichi Forging Co., Inc. (forged parts).

Philippine exports of automotive parts reached around 4.59% of total exports in 2005 amounting to almost $2 billion. Automotive parts and components have been a strong export performer,

almost doubling in value in the past five years (Figure 6), and are far greater in value than exports of motor vehicles, motorcycles, and motorcycle parts.

Figure 6: Exports of automotive and related products, 2000-2005

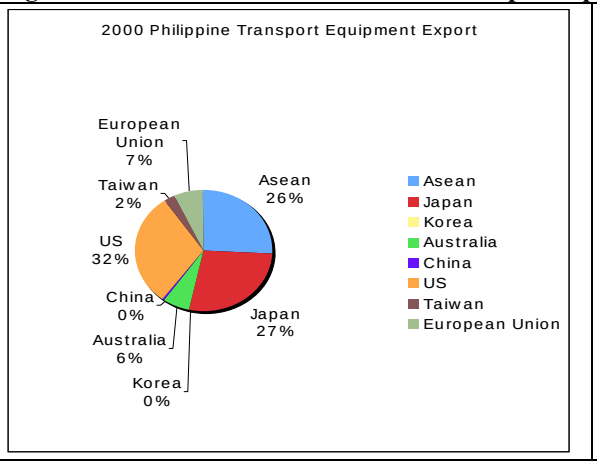


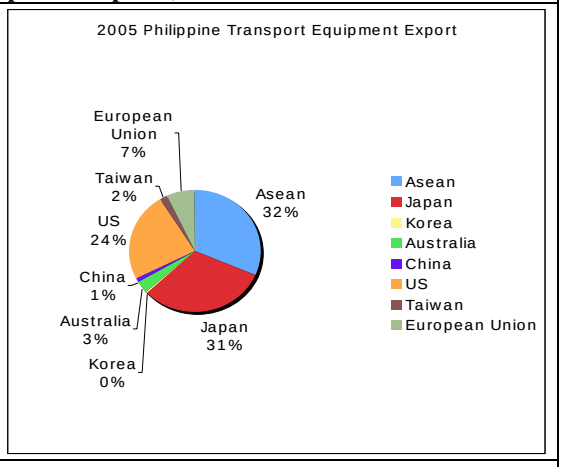
Source: Department of Trade and Industry, Tradeline Data

Implications on ROO. One of striking features of Philippine trade in the motor vehicle and parts industry is that the level of intra-ASEAN trade has actually increased over the period 2000-05. ASEAN's share in Philippine motor vehicle exports has risen from 26% to 32% while its share in Philippine imports of motor vehicles and parts has increased from 13% to 37%. Japan, which has been traditionally the dominant motor vehicle exporter to the Philippines has seen its share in total Philippine imports in this sector fall by almost half (60% to 29%) over the five year span. The United States, which accounted for a third of the Philippine exports in 2000, experienced a fall in its share to 24% in 2005.

Trade in finished motor vehicles between the ASEAN and the Philippines has also been growing fast. In 2004 and 2005, the volume of Philippine exports of motor vehicles was around 4 to 5 times the export values in 2000. Exports of completely built units of Philippine-made Ford cars to the region grew particularly fast in 2004; the Ford Motor Company exported 10,423 CBU units in 2004, around 91.0% of all CBU units exported within the year. In terms of value, Ford exports CBU units of the Lynx, Escape and Focus as well as the Mazda 3 and Tribute models to other Asian markets such as Thailand, Indonesia, Singapore and Malaysia. Imports from ASEAN in 2005 rose to around three times their value in 2000.

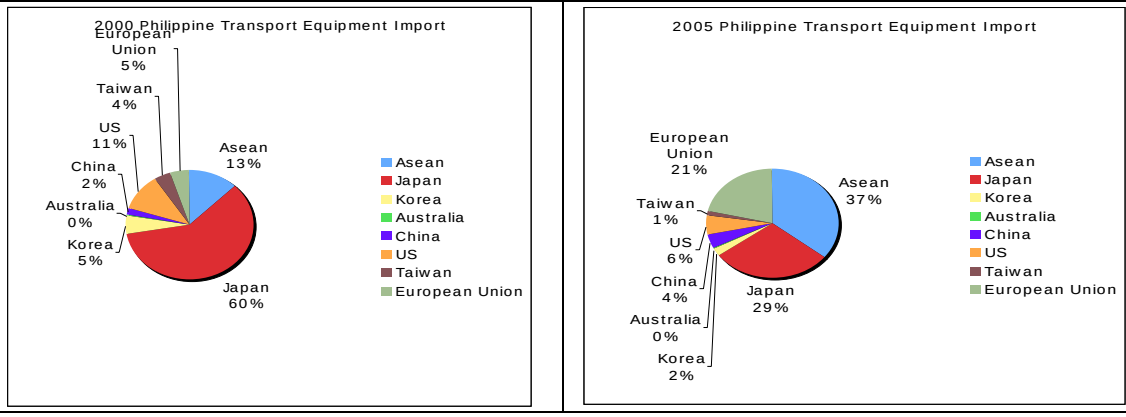
Figure 7: Distribution of destination of transport equipment exports, 2000 and 2005





Source: Department of Trade and Industry, Tradeline Data

Figure 8: Sources of Philippine imports of transport equipment



Source: Department of Trade and Industry, Tradeline Data

The changes in the trade profile of the motor vehicle industry reflect partly the underlying structural shift of the regional motor vehicle industry. Over the years Japan has invested heavily in setting up production facilities in ASEAN to take advantage of lower costs in the region, including more competitive exchange rates. In addition, rising incomes in the ASEAN region made it a more promising and lucrative market for different car brands. An integrated ASEAN was expected to see 1.6 million vehicle sales in 2005 and 2.3 million by 2010.[4] In addition, given the technical possibilities of outsourcing vehicle components and parts, and the benefits of scale economies from specialization, MNC production strategies have taken on a more regional scope (Austria, 2004). The evolving strategies involve designating specific production units of an MNC to specialize in manufacturing a specific vehicle model and to subsequently export it to the region under the preferential tariffs (CEPT). For example, pick-up production has dramatically increased in Thailand, while the Philippines and Indonesia have seen increasing dominance in passenger cars and utility vehicles respectively. The cost savings arising from this strategy could partially explain the relatively high levels of motor vehicle trade in the Philippines that invoke the preferential tariff rates under AFTA.

Automotive trade is one of the most important trade activities conducted under the CEPT, making ROO very relevant for ASEAN trade integration in the motor vehicle sector. For the relatively large ASEAN markets of Indonesia, Malaysia, Thailand and Vietnam, motor vehicle exports from the Philippines are important under the preferential trading system of CEPT (Table 5). Motor vehicle imports from ASEAN countries into the Philippines under CEPT are not as large, except for imports from Thailand. The large volume of trade in motor vehicles under the CEPT suggests that the existing ROO are not a barrier. The high use of ASEAN-CEPT in motor vehicles is due to several factors:

Table 5: Share of motor vehicles in Philippine trade under CEPT (preliminary estimates)

Member	Percentage of bilateral exports under CEPT	Percentage of bilateral imports under CEPT
Indonesia	30.0%	6.6%
Malaysia	21.6%	8.3%
Singapore	0.6%	0
Thailand	54.8%	35.7%
Vietnam	22.4%	0

Source: Tariff Commission

[4] "Southeast Asia must implement AFTA if auto sector is to boom", http://www.afp-direct.com/abonnes.

First, in contrast to electronics trade where the margin of preference of the CEPT relative to non-ASEAN trade is practically nil, preference margins are considerable for motor vehicles (Table 6). ASEAN is host to two national car development programs (Malaysia and Indonesia). In addition, 'motor vehicles' are deemed modern industries and figure quite prominently in many development programs of ASEAN members. As a result, tariffs have tended to be above the average in order to protect the infant motor vehicle industry in those countries. In the Philippines, the automotive industry developed under a system of protection, regulation and promotion through high tariffs, a local content scheme, and import restrictions (Aldaba, 2000).

Table 6: Philippine tariff rates for selected motor vehicles and parts

Item	HS	MFN (%)	CEPT (%)
Bumpers	8708.1	10	3
Finished Cooling Units	8415.9	10	5
Steering columns and Boxes	8708.94	10	3
Assembled gear Boxes	8708.4	10	3
Drive Axles assembled	8708.5	10	3
Spark Plugs	8511.1	3	3
Gas Engines	84.07	10	3
Air conditioning Units	8415.2	10	5
Fuel Pumps	8413.81	1	0
Gaskets	8484.1	7	3
Lighting Equipment	8512.2	10	5
Shock Absorbers	8708.8	10	5
Wiring Harness	8544.3	15	5
Radiators	8708.91	10	5
Motor Passenger Cars	8703.21.53	30	5
Ordinary lorries	8704.21.26	30	5
Motor Buses	8702.10.01	20	5

Source: Tariff Commission

Second, MNCs strategies entail specialization of specific lines of products in motor vehicles for each country, with the region as the market. Because the size of individual markets in ASEAN is quite small, vertical integration is not a viable option for motor vehicle companies. MNCs production strategies, largely dictated by headquarters in developed markets, seek to optimize efficiency by allocating specific automotive products in different ASEAN countries to benefit from scale economies and take advantage of CEPT preferences.

Third, regional initiatives such as the ASEAN Industrial Cooperation Scheme (AICO) foster intra-ASEAN trade in motor vehicles. The scheme promotes the sharing of industrial activities among ASEAN-based companies. By according these companies with even more generous preferential tariffs than the ones that exist in the CEPT AFTA, the AICO aims at providing greater opportunities for specialization. As companies specialize in limited product coverage for a larger integrated ASEAN market, economies of scale and scope are better exploited and the network of production linkages is further developed. The AICO scheme offers participating ASEAN companies preferential tariffs of 0-5%. The Philippines, in particular, is offering AICO tariff rates between 0 and 1%. However, to qualify for the enhanced preferential tariff, the traded goods should meet the AFTA ROO of at least 40% value added.

The overwhelming majority of the AICO applicants in the Philippines are companies in the motor vehicle industry. Of the 31 AICO applications over the period 1999-2002 (Tariff Commission website), only three applications are not related to the motor vehicles. The AICO arrangement is convenient for MNCs engaged in this sector. For example, the application of Honda Car

Philippines in 1999 involved the trade of completely knocked down component parts for the Honda City and Civic passenger cars to Honda Car Thailand.

4 Conclusion

From the three cases above, it appears that rules of origin are only relevant for the automotive sector. Philippine exports of motor vehicle parts and components take advantage of the margins of preference as its trade with ASEAN countries grows, principally to Thailand and Indonesia. Indeed, in the Philippine case, the majority of the applications for CEPT preferences are made by exporters of automotive parts. The CEPT utilization rate of 15% for Philippine exporters is mostly taken up by the transport equipment sector. On the other hand, ROO seem less relevant for electronics and garments exports. This is primarily due to the low-level of intra-ASEAN trade in these two sectors as the bulk of Philippine electronics and garments products are exported to non-ASEAN markets. Moreover, the margin of preferences, particularly for electronics, is low making restrictive rules of origin irrelevant.

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Chapter 9
Thailand

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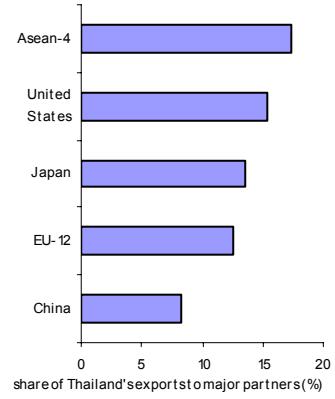
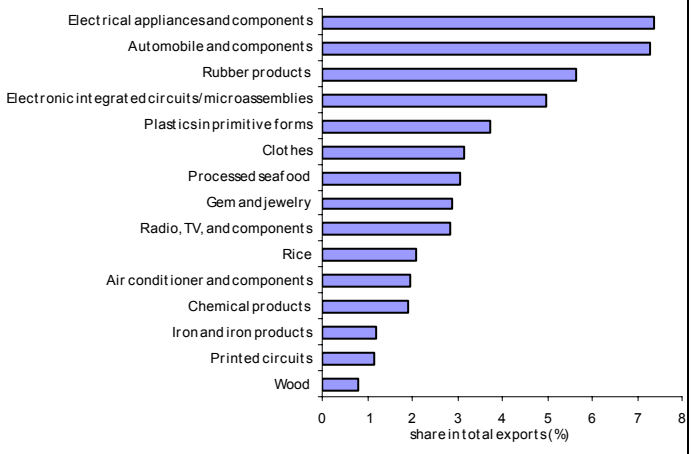
1 Export Profile

Thailand's GDP growth reached 4.5% in 2005, despite some adverse shocks such as the avian flu outbreak, a drought, and the tsunami. Exports grew by 15% to $110 billion. Imports expanded even faster at 26%, especially imports of oil, steel, and gold. The US, EU, Japan, and ASEAN accounted for about two thirds of total exports (Figure 1). High-tech products such as automobiles and components, computer and components, integrated circuits, electrical appliances, plastics and articles, chemical products, and petroleum, accounted for about two-thirds of total exports. Agricultural and agro-industrial products accounted for 16% of total exports. Thailand exported goods worth more than 60% of GDP to the world. Automobile and components were the fastest growing exports, reaching 42% in 2005 compared to 2004, and accounted for 7 percent of Thailand's total exports. Exports of electrical appliances and components also accounted for 7% of total exports followed by rubber products, electronic integrated circuits and micro-assemblies, clothes, and processed seafood.

Figure 1: Thailand's main export markets… and main export products

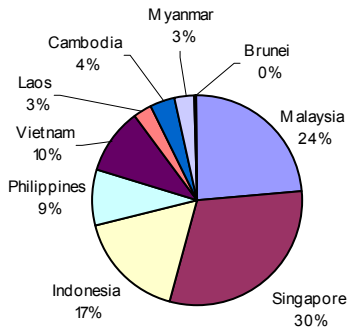




Source: UN COMTRADE

Export to ASEAN. Thailand's exports to ASEAN reached $24 billion in 2005, accounting for 22% of its total exports to the world. Exports to ASEAN increased by 13% from 2004. Within ASEAN, Singapore, Malaysia, and Indonesia are Thailand's main export markets (Figure 2). Machinery, electrical machinery and equipment, mineral fuel oil wax, and vehicles were among the top exports to ASEAN. Thailand exports motor vehicles (HS8703) to Indonesia and the Philippines ($419 million and $247 million, respectively); motor vehicle accessories and parts (HS 8708) to Malaysia ($321 million); and electronic integrated circuits and micro assemblies (HS 8542) to Singapore ($554 million). Exports of rice to Malaysia are also important—at about $139 million.

Figure 2: Thailand exports to ASEAN in 2005



Source: UN COMTRADE

Export to other major markets. Thailand's exports to China reached $9 billion in 2005, growing 28% from 2004. About 28% of exports to China came from machinery, mainly automatic data processing machines, parts and accessories (HS 84)—exports of automatic data processing machines and parts (HS 8471 and HS 8743) reached $1.4 billion. Electrical machinery and equipment (HS 85) represented 14% of total exports to China—exports of electronic integrated circuits and micro-assemblies (HS 8542) reached $381 million. Rubber and rubber products reached 10% of total exports in 2005 followed by plastic and articles for 9%--exports of natural rubber (HS 4001) achieved a record high of $742 million.

Thailand's exports to Japan reached $15 billion in 2005, up 11 % from 2004. About 27 % of total exports to Japan came from electrical machinery and equipment (HS 85)—exports of electronic integrated circuits and micro-assemblies (HS 8542) reached $676 million. Automatic data processing machines, parts, and accessories (HS 84) accounted for 15% of total exports to Japan—Thailand's exports of storage units (HS 8471700) and input/output units (HS 8471600) of automatic data processing machines and units reached $409 million and $186 million respectively. Exports of poultry and products (HS 1602) were at $313 million in 2005.

Thailand's exports to the US increased by 9% from 2004, reaching $17 billion in 2005. The exports of electrical machinery and equipment (HS 85) represented 23% of total exports to the US—export of reception apparatus for television, video monitors and video projectors (HS 8528) was at $906 million; exports of electronic integrated circuits and micro-assemblies (HS 8542) was $600 million. The exports of automatic data processing machines, parts, and accessories (HS 84) accounted for 15% of total export to the US—exports of automatic data processing machines/units and parts (HS 8471 and HS 8473) reached $1.9 billion. Exports of natural rubber (HS 4001) reached $328 million in 2005. Thailand's exports to the EU were $780 million in 2005.

2 Thailand's Free Trade Agreements and Rules of Origin

Thailand has signed bilateral agreements with Australia, New Zealand, India, China, and Bahrain. Negotiations in many trade agreements are still ongoing, including with the US, Japan, Chile, Korea, and EFTA. Although some bilateral agreements were signed and enacted, the utilization of trade preferences has not been fully exploited. Overall, Thailand's exporters do not have difficulties abiding by the rules of origin (ROO) except for some products which need imported raw materials such as canned tuna and specific steel products. In the Thailand-India Early Harvest agreement, ROO are considered challenging due to a key requirement to meet both CTC and LC (Table 1). The Thailand-Australia FTA and the Thailand-Japan CEP allow Thailand's exporters to cumulate the materials imported from other developing countries as originating in Thailand which makes it easier to fulfill the ROO.[1]

[1] *Cumulation or Cumulative Rules of Origin* allows producers to include the imports of raw materials or semi-finished goods from developing countries or ASEAN members in calculating Thailand's local content. For instance, in the Thailand-Australia FTA, producers of textile products can cumulate the costs

Table 1: Rules of origin by FTA

Trade Agreement	Wholly Obtained	Change of Tariff Classification	Local Content	Specific Process	Insufficient Operation	Cumulation
Thailand-Australia	Yes	CTH, CTSH, CTH+SP, CTSH+LC CTSH+SP	40% - 55%	Yes	Yes	Yes
Thailand-New Zealand	Yes	CTH, CTSH, CTH+SP, CTH+LC	40%, 45%, 50%	Yes	Yes	--
Thailand-Japan	Yes	CTH, CTH+LC, CC	60%	--	--	Yes
Thailand-India	Yes	CTH+LC40% CTH+LC20% CTSH+LC40%	20% - 30%	--	--	--

Note: CC = Change of Chapter (2 digits); CTH = Change of Tariff Heading (4 digits); CTSH = Change of Tariff Subheading (6 digits); LC = Local Content; SP = Specific Process
Source: Compiled by Fiscal Policy Research Institute, Thailand

Exports that benefit from preferences are still a small share of total exports. About 15% of total exports made use of preferences in 2005 (with a value of about $17 billion), and about 21% of total exports to ASEAN used preferences under the CEPT in 2005. About 57% of trade preference utilization came from GSP with developed partners (Table 2). Trade preference utilization from FTAs accounted for only 13% of total trade preference utilization. The preference utilizations by exports to China and India were very small due to the short list of items receiving preferences under the Early Harvest agreements (Table 3). The utilization rate for exports to Australia was almost 50% of total exports to Australia or 72% of total FTA utilization to three major FTA partners. Compared with 2005, exports to the major FTA partners between January and March 2006 increased by 32%. The total preference utilization, however, rose by 24% with the highest utilization rate coming from exports to Australia.

Table 2: Thailand's exports using preferences

Category	$ million in 2005	% share in total in 2005
GSP	9,791	57
CEPT	5,020	30
FTA	2,172	13
Total	16,983	100

Source: Ministry of Commerce, Thailand.

Table 3: Thailand's exports using preferences by FTA

Country	$ million in 2005	% share in total in 2005	%utilization rate 2006 (first quarter)
China	429	20	61
India	175	8	11
Australia	1,568	72	73
Total	2,172	100	24

Source: Ministry of Commerce, Thailand.

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of raw materials imported from developing countries up to 25%, as Thai origin, to meet the 40%-55% local content. In the Thailand-Japan CEP, Thai producers can cumulate the raw material imported from ASEAN members as Thai origin. *Insufficient Operation* indicates the manufacturing process that is insufficient for the resulting product to gain origin. Insufficient operations include, for example, repackaging, adding some chemical substances, or diluting products. These operations do not change the main function or characteristics of the products. In the Thailand-Australia and Thailand-New Zealand FTAs, the dilution of products by adding water or solutions is insufficient to receive origin.

Making the rules of origin match with the production process of Thailand. Using the 2001 input-output table for Thailand, production processes in various sectors were mapped with the rule of origin for which compliance would be possible. Major exports were then ranked according to their ability in matching the rule of origin (Table 4). For garments, handbags and shoes, and furniture, it seems that rules of origin, which generally do not require more than 60% local content, should be relatively easy to meet. On the other hand, products such as chemicals, glass, and pharmaceuticals, which have a local content of less than 20% according to Table 4 below, would find it more difficult to meet local content requirements and therefore qualify for preferences.

Table 4: Ranking of exported products according to their local content

HS Code	Product Descriptions	Local Content (%)
1108	Starches and Starch Products	>60%
4201-4206	Handbag, Luggage, and Similar Products	>60%
6401-6406	Shoes and Parts	>60%
6101-6117	Cloths excluding those made of wool	>60%
1701-1704	Sugar	>60%
9401-9406	Furniture and House Ware	>60%
2001-2009	Some Food Products	>60%
6301-6310	Garment excluding Cloths	>60%
69	Non-fire-resistant Ceramic Products not for Construction	>60%
2203-2204	Malt and Alcoholic Drinks from Malt	40% < LC < 60 %
0801-07, 0814	Processed and Reserved Fruits and Vegetables	40% < LC < 60 %
1901-1902, 1903-1905	Bread Products	40% < LC < 60 %
95	Toys	40% < LC < 60 %
5401-5406	Long Synthetic Fiber	40% < LC < 60 %
8701-8716	Motor Vehicle and Engine	20% < LC < 40 %
0201-0210	Processed and Reserved Meat	20% < LC < 40 %
4001-4017	Natural Rubber and Rubber Products	20% < LC < 40 %
96	Sport wares	20% < LC < 40 %
4401-4421	Wood and wood products	20% < LC < 40 %
0401-0410	Dairy Products	< 20%
82	Specific Steel Products	< 20%
3001-3006	Pharmaceutical Products, Medical Supply and Herbal Products	< 20%
3901-3926	Plastics in Primitive Forms and Synthetic Rubber	< 20%
3401-3407	Cleaning and Shining Products, Perfume and Similar Products	< 20%
73	Precious Metal excluding Primitive Steel and Steel	< 20%
3801-3825	Specific Chemical Products	< 20%
7001-7020	Glass and Glassware	< 20%
7201-7229	Steel and Primitive Steel	< 20%
5301-5311	Woven Fabrics (from plants) and Fabric Products	< 20%
90	Optical Photo Cine Apparatus	< 20%
81	Cutter, handheld Machine and Similar Products	< 20%
6001-6006	Textiles and Products from Knitting and Crochet	< 20%
76	Products with Steel Foundation	< 20%
78	Mineral Products excluding Metal Products	< 20%
2801-2851	Primitive Chemical Products excluding Fertilizer and Nitrogen Containing Products	< 20%

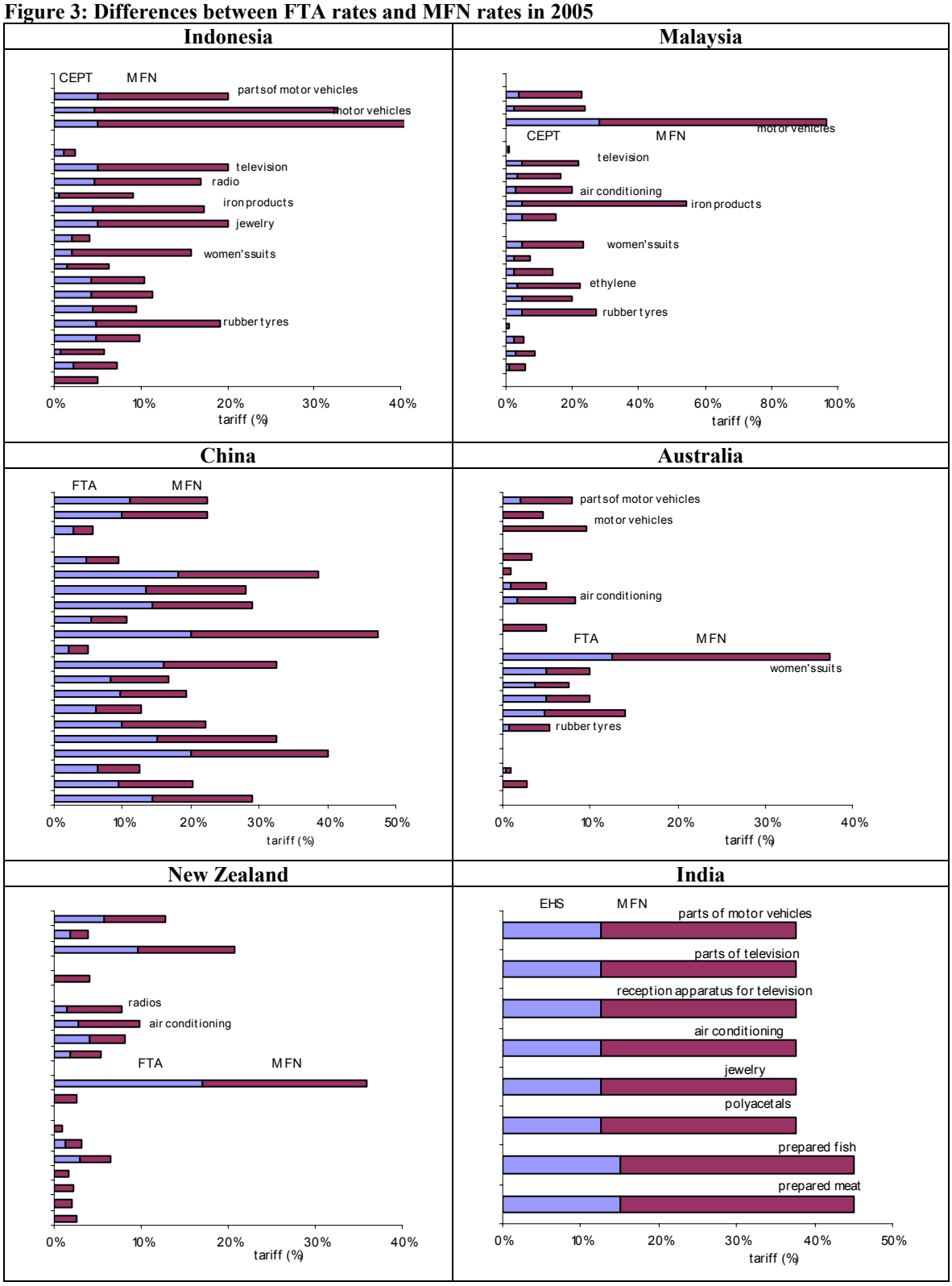
Source: Fiscal Policy Research Institute, 2006

3 What Discourages the Use of Preferences?

The differences in preference utilization rates among FTAs can be explained by 1) the amount of differences between FTA rates and MFN rates; 2) protective ROO; and 3) administrative difficulties in acquiring the trade preferences. Thailand's exporters generally do not face administrative difficulties since the process is designed to facilitate the utilization of trade preferences (the details can be found at the Department of Foreign Trade's website). Rather, the problem seems to be the reliability of information on the cost structure of exported goods which makes it hard to determine whether they are eligible for preferences. For some products, ROO are considered to be constraining as in the case of canned tuna and specific steel products.

Figure 3 compares MFN rates and FTA rates by major export categories imposed by selected countries. In ASEAN, Malaysia's MFN rates are higher than those of Indonesia in many items. The CEPT rates, however, are not obviously different between Malaysia and Indonesia except for some items such as automobile and articles, natural rubber and rubber products, and women's clothes. Considering the average margin between MFN and CEPT rates, that of Indonesia at 7.58 % is lower than that for Malaysia at 10.73%. This explains partly the different utilization rates for the same goods exported to Indonesia and Malaysia. The average preference margin for China is 1.03 % which is minimal compared to 13.13 % for India; even though the MFN rates are considerably high for these countries. The relatively small reduction in tariffs is not enough to persuade the exporters to apply for the preferences.

Figure 3: Differences between FTA rates and MFN rates in 2005



Note: bars are stacked rather than indicating totals
Source: UNCTAD COMTRADE

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Chapter 10
Vietnam

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1 Export Profile

Vietnam's openness to trade started in the early 1990s. Since then, its export performance has been phenomenal. Exports more than doubled in the past decade—from less than $9 billion in 1997 to $20 billion in 2003 (Figure 1). Vietnam's exports are mainly made up of light manufacturing, which accounts for more than 40% of total exports. Within light manufacturing, textile and garments are the most important products, with exports reaching $5 billion in 2005 or 17% of total export. The second most important product is crude oil, accounting for 32% of total export in 2005. Agricultural products are the third largest exports, with key products including rice, coffee, and cashew nuts. In recent years, especially since 2000, exports of fishery products have risen, and now account for 10% of total exports.

The main destinations of Vietnam's exports are outside the region, namely the United States, Europe, and Japan. Exports to ASEAN are around 15% of the total, and their share has been declining over time as Vietnam gained better access to the US market since the US-BTA came into effect. Within ASEAN, most of the Vietnamese exports go to Singapore, followed by Indonesia and Malaysia (Figure 2).

Figure 1: Vietnam's export profile

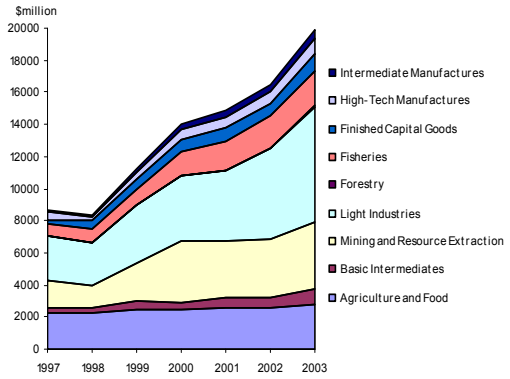
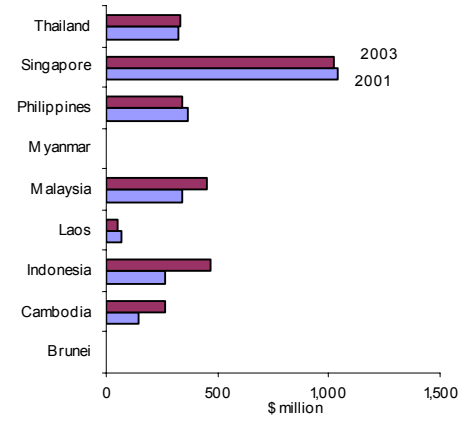


Figure 2: Vietnam's exports to the region



Source: Ministry of Trade

2 Preferential Agreements and Rules of Origin

Since Vietnam opened up its trade in the early 1990s, the country has moved to participate in regional and bilateral agreements, and recently joined the WTO. The first regional trade arrangement in which Vietnam was engaged is the ASEAN Free Trade Agreement. As a member of ASEAN, Vietnam is negotiating further expansion of the agreement through the ASEAN-China, ASEAN-Korea, ASEAN-Japan, and ASEAN-India FTAs. The most important and comprehensive bilateral trade agreement of Vietnam is that with the United States, which is fully based on the WTO principles. In addition, Vietnam has signed bilateral investment agreements with a number of other countries—the most significant in terms of economic impact being the

Vietnam-Japan Agreement on Investment Liberalization, Protection, and Promotion, due to the substantial trade and investment relationship between the two economies. Vietnam also signed the Vietnam-EU Framework Cooperation Agreement, which facilitates doing business for investors and traders of the two partners in each other's territory. It also contains substantial development assistance from the EU to Vietnam. In terms of multilateral trade, Vietnam recently became a WTO member (end-2006) and obtained Permanent Normal Trade Relations from the US.

Rules of origin under ASEAN CEPT. Under the ASEAN CEPT, imported goods with at least 40% ASEAN content are eligible for preferential tariffs commonly applied within the ASEAN FTA, implying that cumulation across the region is possible. Cumulation means that products which are used in a Member State as inputs for a finished product eligible for preferential treatment in another Member States shall be considered as products originating in the Member State where working or processing of the finished product has taken place provided that the aggregate ASEAN content of the final product is not less than 40%. The formula for determining ASEAN content is as follows:

(Value of non-ASEAN materials, parts, produce + Value of undetermined origin materials, parts, produce)/FOB price ≤ 60%

Administration of Certificates of Origin. The administration of the Certificate of Origin (CO) is handled by the Vietnam Chamber of Commerce (VCCI) and the Ministry of Trade or its appointed agents. While VCCI is responsible for granting ordinary (non-preferential) COs, the Ministry of Trade and its appointed agents are responsible for granting COs to goods that are eligible for preferential treatments under treaties between Vietnam and other countries, groups of countries, or international economic institutions. COs for goods manufactured in industrial zones or export processing zones are issued by the Management of such zones.

For the COs under the CEPT, or Form D Certificate (Box 1), the Ministry of Trade has appointed 7 Regional Bureaus of Export-Import Management to issue this certificate to firms in the respective locations throughout the country. Applicants submit the application form, certificate of examination for origin (if required), customs clearance form, commercial receipts, and bill of lading to obtain the Form D. The Regional Bureau of Export-Import Management issues the form within 12 working hours in normal cases, and within 24 working hours in case there is the need for examination of manufacturing facilities or other documents are needed for verification (Box 2).

In general, the Form D certificate is issued by the designated authority in the government of the exporting Member State. It is submitted to the Customs Authority of the importing Member State within 4 months from the time it was signed by the designated authority in the exporting country (or 6 months if the goods pass through one or more non-ASEAN countries). The importing country may request a retroactive check on a random basis and/or any time it doubts the validity of the documents or accuracy of information. The Customs Authority in the importing Member State may temporarily suspend the preferential treatment while waiting for the result of the inquiry. In case of disputes about the identification of origin, classification of goods, or other matters, the related competent authorities of importing and exporting Member States consult about the solution and the result is notified to all other Member States. In case the dispute cannot be resolved bilaterally, the case is decided by the Senior Economic Official Meeting (SEOM).

Box 1: ORIGINAL (DUPLICATE/TRIPLICATE/QUADRUPLICATE)

1. Goods consigned from (Export business name, address, country)		Reference No. ASEAN COMMON EFFECTIVE PREFERENTIAL TARIFF SCHEME CERTIFICATE OF ORIGIN (Combined Declaration and Certificate) FORM D			
2. Goods consigned to (Consigner's name, address, country)		Issued in _____ (Country) See Notes Over			
3. Means of transport and route (as far as known) Departure Date Vessel's name/Aircraft etc. Port of Discharge		4. For Official Use Preferential Treatment Given Under ASEAN Common Effective Preferential Tariff Scheme Preferential Treatment Not Given (Please state reasons) ..... Signature of Authorized Signatory of the Importing Country			
5. Item number	6. Marks and numbers on packages	7. Number and type of packages, description of goods (including quantity where appropriate and HS Number of the importing country)	8. Origin criterion (see Notes overleaf)	9. Gross weight or other quantity and value (FOB)	10. Number and data of invoices
11. Declaration by the exporter The undersigned hereby declares that the above details and statement are correct: that all the goods were produced in ---------- (Country) and that they comply with the origin requirements specified for those goods in the ASEAN Common Effective Preferential Tariff Scheme for the goods exported to ---------- (Importing Country) ---------- Place and date, signature of authorized signatory			12. Certification It is hereby certified, on the basis of control carried out, that the declaration by the exporter is correct. ---------- Place and date, signature and stamp of certifying authority		

Source: Ministry of Trade

Box 2: Procedures for issuing Form D in Vietnam

- The Form D certificate shall be provided in 1 original and 3 copies.
- Application file for Form D shall include: 1. Application form (as issued by the Ministry of Trade) fully completed; 2. Certificate of examination of good's origin (in case examination is required) shall comply with regulations on origin provided in Annex 1 of this Regulation, and shall be issued by the Export-Import Examination Company, Ministry of Trade; 3. Customs form that has been cleared; 4. Commercial receipt; 5. Bill of lading.
- Documents 3, 4, and 5 shall be a copy with signature and stamp for true copy of the head of the organization (for institutions) or the public notary (for individuals), with original for comparison.
- Form D applicant shall be fully responsible before the law for the faithfulness of the details provided in the Form D certificate.
- When necessary, the Department of Export-Import Management may: a) Ask the Form D applicant to provide other documents to certify the origin of goods, based on CEPT criteria; b) Examine at the manufacturing facility; c) Re-examine issued Form D certificate.
- Time for Form D issuance: The Regional Bureau of Export-Import Management shall be responsible for issuing Form D certificate within the following period of time upon receiving the legitimate files for Form D application:
  - within 12 working hours for normal cases;
  - within 24 working hours for cases mentioned in paragraph a, Article 7;
  - in special cases, the time can be longer, but shall not exceed 15 working days.
- In cases mentioned in Article 18, the Regional Bureau of Export-Import Management shall issue a Form D certificate to the goods submitted within 1 year from the date of delivery. A Form D certificate issued in this case shall bear the mark "Issued retroactively" in Box 12 of Form D.
- In case of loss, misplacement, or damage of Form D, the Regional Bureau of Export-Import Management may reissue the original Form D certificate and the triplicate within 15 days upon receiving application for reissuance, attached with a quadruplicate of the first issuance, with the mark "Certified true copy" in English in Box 12.
- In case the goods do not meet the criteria, or origin cannot be traced, based on the criteria under CEPT, or the application for reissuance lacks a quadruplicate of Form D for the first issuance, the Regional Bureau of Export-Import Management have the right to refuse the issuance of Form D, and shall inform the applicant about the reason within the period specified above.
- If refused for Form D certificate issuance, or not granted within the period mentioned in Articles 8 and 10, the applicant shall have the right to send a complaint to the Minister of Trade within 15 days upon receiving the decision for refusal of Form D issuance, or the last day of the deadline for issuing Form D. The Minister of Trade shall be responsible for settling the complaint within 5 days upon receiving. The decision by the Minister of Trade shall be final.

Source: Ministry of Trade

Utilization of preferences. The rising exports to ASEAN benefiting from the CEPT scheme after 2000, and the sharp increase since 2003, coincide with the gradual phase-out of tariffs under AFTA (Figure 3 and Figure 4). The number of firms' applications for Form D (for tariff preference under CEPT) also increased dramatically after 2000, especially after 2003 (Figure 5). This trend indicates a rising number of firms using the CEPT to benefit from the preferential tariff treatment while exporting to the region. The value of goods exported through the CEPT scheme also increased strongly after 2003, and more than doubled between 2003 and 2004 (Figure 6). Despite the increase in utilization rate of preferences, the share of exports to ASEAN benefiting from preferences remains low—at around 8%.

Figure 3: AFTA CEPT vs MFN tariffs in 2003

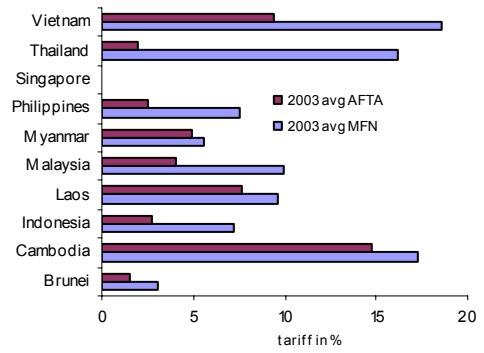


Figure 4: Vietnam's exports to ASEAN benefiting from CEPT are growing

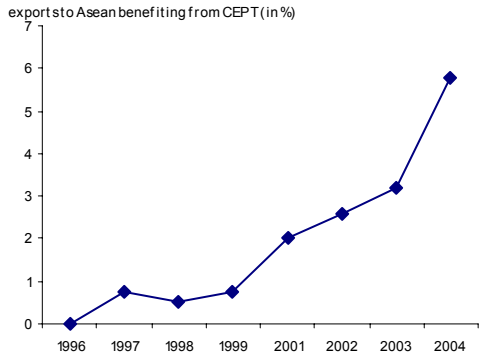


Figure 5: Growing use of Form D applications…

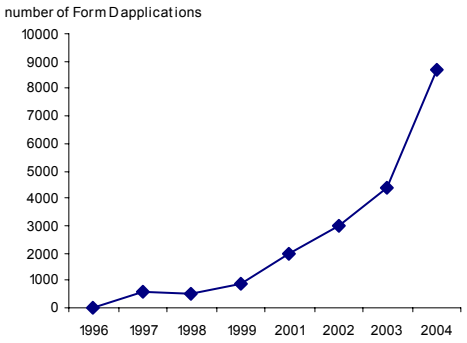
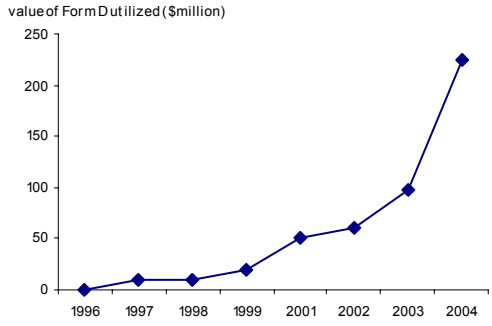


Figure 6: … and growing value of exports utilizing Form D



Source: Ministry of Trade

3 Findings from Survey and Interviews

The firm survey on rules of origin was conducted between February and April 2006 in the Hanoi area. About 20 firms involved in import and export were interviewed—7 in manufacturing industries, including electronics, metal work, paper products, footwear, ceramics, detergent; 7 in textiles and garments; 3 in food processing; and 3 in cars and motorcycles and parts.

Form D procedures are confusing to small and new firms but not to large or joint venture firms. The general response from the surveyed firms indicates that the Form D application procedures may be time consuming for first time applicants, especially for small importers who import for their own production. These firms may not be fully aware of the procedures and the required documents, or their eligibility, and hence are confused about how to obtain the certificate. Also, firms often did not know the HS code for the materials they imported, and as a result paid the non-preferential tariff rate attached by the customs officer. For larger importers, and those who have gone through the procedures many times, Form D procedures do not seem to pose a problem, especially for those who import the same items over and over again. Professional trading firms that are not involved in any production also report the easy steps and positive experience with Form D applications. Joint venture firms and state-owned firms tend to have longer vintage in the market and are more aware about the ASEAN CEPT and tariff preferential treatment. On the other hand, local private firms tend to be new to the market and unaware of any trade regime that affects their business. The survey responses suggest that the priority is to

facilitate the procedures to use Form D for new local firms, as well as for small and medium firms.

Because firms do not import or export directly, they often do not use preferences. Most firms in the sample do not import materials from ASEAN countries to produce for export to ASEAN countries. They either import materials from ASEAN and then produce for export to non-ASEAN markets, or they import from non-ASEAN countries to produce for export to both ASEAN and non-ASEAN countries. In this regard, the ASEAN content requirement is irrelevant for them. Further, although most firms in the survey import materials or export their products, they do not all import or export directly. For example, metal work firms use imported steel as their raw materials, but do not import them directly—they just buy imported steel domestically, hence are unaware of any tariff preferences. Not all exporting firms can export directly. For example, textile and garment firms usually produce on a subcontracting basis, with cut-make-trim being the key activities. Therefore, the source of materials or the destination of their products is not important to them. They subcontract to regional buyers who have offices in Vietnam or other countries in the region, indicate the suppliers, and finance the imports of materials. Hence, for the textile and garment industries, it is the regional buyers or intermediaries, not the Vietnamese firms, who deal with the trade regime while sourcing materials and processing regionally. The automobile industry is the only case identified by this survey where firms have an incentive to alter their source of import of intermediate input to benefit from the CEPT.

Delays involved in processing Form D are a disincentive to its use. Most firms complain about the time consuming customs clearance, port handling, and other procedures that slow down their business, and add to their costs (Table 1). Ten out of 19 firms reported irregular payment to obtain product approval. A number of firms are aware of the tariff preferences for materials imported from ASEAN countries. However, they report a time consuming application process—filling in the form and waiting for approval—which often means missing deadlines to meet an export order and hence missing an export opportunity. These firms therefore prefer to import materials of the best quality and price, with prompt delivery so that they can meet their buyer's order, instead of spending time, trying to obtain tariff preferences.

Table 1: Results of firm survey on the use of CEPT

Type of firm	Have you experienced any difficulties in meeting the ASEAN rules of origin?	Have you modified your sourcing of inputs in order to meet the ASEAN rules of origin?	Comments
Manufacturing	no	no	Raw materials are sourced according to their quality and appropriateness for production and not purely based on their price.
Manufacturing	no	yes	The targeted market is domestic
Manufacturing	no	no	Raw materials are sourced according to their quality and appropriateness for production and not purely based on their price.
Textiles and garments	no	yes	No significant implications
Textiles and garments	no	no	The company imports some raw materials from ASEAN, but mainly exports to the EU and North America.
Textiles and garments	no	no	The share of materials imported from ASEAN is very small and the company mainly exports to non-ASEAN countries. In general it would be difficult to change suppliers, since the company processes by order from buyers, hence most materials are sourced by the buyer.
Processed food	no	yes	Firm's objective is to ensure quality, even if production costs may increase.
Automobiles	no	yes	Reduction of tariff payments is seen as a way to increase the profit.
Automobiles	no	n/a	Raw materials are sourced according to their quality and appropriateness for production and not purely based on their price.

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