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ANIBAL PINTO
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EUGENIO LAHERA
Technical Secretary



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Rules of origin: *new implications*

Eduardo Gitli

International expert on trade policy and international negotiations, Senior Technical Adviser and Consultant to UNCTAD, Visiting Professor at the International Centre on Economic Policy for Sustainable Development, National University, Costa Rica.

As a subject of international negotiations, rules of origin have been of interest since the early 1970s, but in recent years they have come to be regarded as a new form of protectionism and have figured prominently in the spate of trade negotiations which have been initiated or carried forward in the Americas since the late 1980s. The trade schemes negotiated under the terms of the new treaties thus adopted make it possible to extend the protection of intermediate inputs from one signatory country to another. Therefore, the advantages associated with a free trade area are no longer determined solely by each country's system of protection but have instead come to depend upon their trading partners having low trade barriers as well. Moreover, any country gaining access to a trading partner's market must "share the preference" with the party benefiting from the rules of origin in the other country. The smaller the country engaged in negotiations is, the more severely constrained it will be if it accepts restrictive rules of origin. Furthermore, the "one-on-one" system of negotiations has the disadvantage of preventing accumulation for the purpose of qualifying under rules of origin, which discourages private investment. In view of this situation, it has been suggested that joint Latin American negotiations should be undertaken on rules of origin. In the author's opinion, defining such regulations at the individual country level is not feasible under existing conditions. As for the general rules, it would be difficult to move beyond what was agreed in the Uruguay Round, which was not a great deal. Accordingly, it would be more meaningful to work on a concept of asymmetry that allows for the recognition that, above and beyond the problem of differing levels of development, the relative size of the countries involved is also a factor and that this element gives rise to striking differences in the web of production linkages.

I

Introduction

The subject of non-tariff barriers began to receive widespread attention as successive rounds of multi-lateral negotiations led to a progressive reduction in developed countries' tariffs during the 1960s and 1970s, even though such barriers had existed long before that time. The campaign against dumping on the part of the Latin American countries did not begin until the late 1980s (and in some countries has not really begun even yet), even though the practice of dumping is as old as international trade itself. The reason for this is that trade liberalization has increased the countries' exposure. The same can be said of rules of origin, which, as reciprocal liberalization processes become more complex, come to be regarded as new instruments of protection. This article seeks to provide some further thoughts about just what is being negotiated and in what direction these emerging schemes are leading us.

Rules of origin are a set of regulations that determine where a given good has been produced. Under completely normal trading conditions, this information would be of little importance or would be useful only for statistical purposes. However, in many cases transborder merchandise trade flows are subject to differing regulatory provisions depending on the type of product involved and where it comes from.

The fact that good AA is transported across the territory of country XX to reach country YY, after a company located in country XX has sold it to a firm in country YY, does not make country XX the point of origin of that good. Although the customs records indicate that the product comes from country XX and it is recorded as such in foreign trade statistics, there may be many circumstances under which the customs authorities' treatment of that product will depend on what its true point of origin is determined to have been. Let us look at some examples:

i) Under the terms of the Multifibre Agreement, industrialized countries place quotas on imports of textile products and garments from developing countries. Some countries might try to sidestep the quota

by routing their products to the market via a third country which does not export many goods of this type. In order to make it even more difficult to detect this practice, it might also subject the final product to some negligible form of processing, such as changing its label or packaging. Therefore, it becomes necessary to determine what combination of processing operations will be considered to have changed the merchandise's "nationality", thus making it eligible for a given quota.

ii) Two countries establish a free trade zone with one another but maintain their original tariffs (which, we will assume, are different) for trade with the rest of the world. What would obviously occur under such circumstances—in the absence of rules of origin—is that products would enter the zone through the country having the lower tariff and would then be transferred from there to the country with the higher tariff. As in the first example, in order to prevent this manoeuvre from being discovered, the entrepreneur from outside the zone would make some trivial change in the product as a way of evading customs controls. Determining whether these changes are significant enough to have converted imported inputs into a nationally-produced item that may then be sold within the zone without being subject to further tariffs is one of the purposes of rules of origin.

iii) The General Agreement on Tariffs and Trade (GATT) grants most-favoured-nation (MFN) status to participating countries. Some nations, such as the United States, have higher tariffs for non-member countries or for those to which they do not wish to award this status for political reasons (e.g., Vietnam). In such cases, criteria for the application of the corresponding tariff are needed.

In each of the above situations we might be talking about different rules of origin, even for the same applicant country. Moreover, rules of origin often differ from one country or situation to the next. We will come back to this subject later on.

II

A typology of rules of origin

Although it is not a commonly-known fact, the current typology of rules of origin was established with the signing of the Kyoto international convention for the simplification and standardization of customs formalities on 18 May 1973. This Convention, which was drafted under the auspices of the Customs Co-operation Council, calls for a series of measures whose main purpose was the organization of future activities in these fields. The most interesting portion of that Convention in terms of the subject under consideration here is found in annex D.1, which deals with rules of origin, because little or nothing of substance has changed since those "old" definitions were formulated.¹

This annex lays down two criteria. First, if the article in question has been produced entirely in a given country (whether by means of relatively primitive systems of mining, harvesting, fishing, etc. or by using inputs that were themselves produced in the country), then there is no doubt as to the national origin of the product concerned.

Second, if more than one country has taken part in the production of a given article (whether by providing materials or labour) then, in order for a product to acquire a specific nationality, it must have undergone a "substantial transformation"; this can be defined in various ways: i) based on the fact that the article has undergone a change in the applicable tariff classification; ii) based on the list of processing operations that do or do not allow a product to qualify as originating from the country in which those operations were performed; and iii) based on the *ad valorem* rule, in cases where the value content of the products used or the percentage by which an item's value has increased while in a given country reaches a specified level.

One pre-existing method that was not specified in Kyoto involves the use of content percentages determined on a non-*ad valorem* basis, primarily in the case of mixtures (e.g., the content of wool by weight or of mixed juices by volume). The North American Free Trade Agreement (NAFTA) abounds with examples of this type of system.

Annex D.1 to the Convention does not define what constitutes a "substantial transformation" (the quotation marks appear in the original text), even in abstract terms. The United States Customs Service considers "substantial" processing to have taken place when an item has undergone a production process that causes its name, characteristics and use to differ from those of the materials used in its production. The three possible types of qualifying transformations will be examined below.

1. Change in tariff classification

At the simplest level, the concept of a change in tariff classification establishes that an article will be considered to be an originating good if the tariff classification of the final product differs from the classifications of the intermediate imported materials used to produce it. The appealing simplicity of this definition fades away, however, when one realizes that the existing basis for the classification of merchandise is the Harmonized Commodity Description and Coding System, which was formulated with a view to customs identification and statistical considerations and is based on broad processing criteria. The realm of production is much more varied than the categories used in the Harmonized System, and a change in tariff classification may involve a change between chapters (two digits), headings (four digits), subheadings (six digits) or tariff items (eight to ten digits).

The problem does not lie in the application of the Harmonized System, which is much more recent than the Kyoto International Convention, but rather in the original conceptualization of this approach as formulated in 1973, when it was thought (adequate practical experience in this regard was lacking at the

¹ Annex D.1 of the Kyoto International Convention gives general definitions for the various rules of origin and weighs their advantages and disadvantages, but it does not identify any optimum package of rules and procedures.

time) that the requirement relating to changes in tariff classifications could take the form of a general rule whereby, for example, the change in classification would be defined as a change from one tariff heading to another (four digits) plus a list of exceptions. The actual situation has proved to be more complicated than that.

Obviously, characterizing a change in tariff classification as a change from one chapter to another (there are 97 chapters in the Harmonized System) is too narrow a definition. Two different products may fall under a single tariff heading even though one of those products is used to make the other, and the two would therefore differ substantially in terms of the amount of processing they involve. For example, in chapter 95, "Toys", there may be a toy that is a combination of several different pieces; for example, toys that represent animals (9503.30), when put together with domestically-produced and packaged models of mangers and human figures, may become Christmas articles (9505.10). In such a case it is easy to see that the final good has undergone a substantial transformation. Nevertheless, if the final product were classified under the same heading as one of its major inputs (9503) –for instance, because it did not fit in the category of "Christmas articles"– it would remain under the same heading and would therefore not qualify as an originating good. For reasons such as this, changes in tariff classifications are defined on a case-by-case basis by the treaty negotiators of each country; it is at this point that the various business interests come into play.²

2. List of processing operations

Under this method, comprehensive lists are normally used which describe, product by product, the technical procedures deemed to be of sufficient importance. The advantage of this approach is that the relevant criteria can be standardized in cases where the operations involved are sufficiently general in nature. However, the diversity of cases and the complexity

of production processes make its application very difficult. Although this approach is generally used in a positive sense, all sets of rules of origin include a list of operations that do not qualify the product as an originating good (e.g., assembly, dilution, etc.).

3. Ad valorem rule

This appears to be the simplest procedure for determining the origin of merchandise and, although it has been very controversial, it is one of the most widely used. It seems logical, as well as being the most reasonable approach, to equate the concept of a "substantial transformation" with an equivalent change in market value. No matter how complex production processes or changes in tariffs may be, there has to be some value-based criterion for determining when an article has been sufficiently "transformed". The value added by such processing can be computed as a minimum percentage of the total value of the good that has been generated within the country. For example, the United States Generalized System of Preferences, the Caribbean Basin Initiative and the United States free trade agreement with Israel all use the criterion of a minimum of 35% national content for total direct operating costs and materials. Other agreements, such as the Latin American Integration Association (ALADI) and the former Free Trade Agreement between the United States and Canada, set the level at 50%. We will return to these questions later on in this article.

Many criticisms have been made of this method which should be noted here:

i) Difficulties arise in borderline cases where a small difference may determine a product's country of origin.

ii) In many cases these differences arise from changes in a final product's relative prices with respect to its various inputs, which may be due to changes in international prices or to currency fluctuations.

iii) One important objection becomes apparent only in the case of non-unilateral commitments. Differences between the cost of labour in countries at different stages of development generate different percentages of national value added and may thus lead to incongruous situations in which the same good, even when it has been produced using similar technological processes, qualifies as an originating good when it is made in the United States but not

² In fact, one of the first complaints to be submitted regarding the interpretation of rules of origin in respect of the North American Free Trade Agreement had to do with toys. Under the rules of origin of the Generalized System of Preferences (GSP), there was no barrier to the movement of toys from Mexico into the United States, but the requirement of a change in tariff classification raised difficulties (*Journal of Commerce*, 1 March 1994).

when it is produced in Mexico (Morici, 1991). This kind of problem arises when the *ad valorem* criterion is applied reciprocally between countries with large wage differentials.

iv) Difficulties have been raised by the fact that the early definitions of "national content", although conceptually clear, were not precise enough for purposes of business calculations. Specifically, when it comes to adding the cost of materials to direct processing costs, a problem arises in arriving at an accounting definition of the latter, which should include labour costs plus assignable capital costs (depreciation, imputed land rent). Overhead costs that are difficult to impute are left out of the calculations altogether. Finally, there is also a difference between computing national content residually (total value less imported content) and calculating it "directly" (domestically-produced materials plus direct operating costs); in the latter case, the definition of the factors involved raises serious problems.

In short, there is more than one way to define the concept of "substantial transformation"; there are various interests involved, and these interests are ex-

pressed in different combinations of criteria. If the determination of product nationality is left to government negotiators, then the pressure brought to bear by private sectoral interests will be a very influential factor in the negotiations. And this is where everything really gets complicated. From a technical standpoint, it is easier to talk about allowable time periods for tariff reductions (0, 5 and 10 years, and even 15 years in exceptional cases) because even though entrepreneurs may try to exert their influence, sooner or later they are bound to fall into one of these categories and end up –by means of a process that may take differing amounts of time– with a zero-level tariff. In contrast, the possible combinations of criteria for defining rules of origin are numerous and remain in place indefinitely, or at least until they are renegotiated.

It should be noted that in these cases the concept of a "substantial transformation" is not based on any clearly measurable principle whatsoever.³ Instead, it is defined by the relevant countries' negotiators, who trade off the pressures exerted by their respective industries among themselves.

III

The rules-of-origin spectrum

As noted earlier, all agreements concerning special treatment in connection with tariffs or non-tariff barriers are accompanied by definitions of the criteria to be used in determining the origin of the merchandise in question.

1. General Agreement on Tariffs and Trade (GATT)

Although few people today would regard GATT and its successor, the World Trade Organization (WTO), as preferential trading clubs, that is actually what they are, inasmuch as the corresponding commitments are to be fulfilled only by member countries.

In the Uruguay Round, an agreement on rules of origin was negotiated which deals only with what GATT refers to –ironically enough– as "non-preferential trade policy instruments" (article 1), based on the concept of most-favoured-nation status. In other words, they apply only to general rights as set

forth in GATT, not to preferential agreements such as the GSP. The commitment is to standardize the various countries' rules of origin within a time period of three years. To that end, a Rules of Origin Committee and a Technical Committee are being created under the auspices of the Customs Cooperation Council.

The main criteria to be used in determining a good's origin are the following: i) that the good has been produced entirely in a given country; ii) that it has undergone a substantial transformation resulting in a change in its tariff classification; and iii) that in cases where the above two criteria are insufficient, standards referring to the value content or processing operations may be applied.

³ We need look no further for an example than the NAFTA rules of origin for wearing apparel, under which the determination of a garment's nationality starts with the spinning of the yarn and moves on from there.

2. Generalized System of Preferences (GSP)

No international standard exists under this system. The United States GSP requires that the cost or value of the materials produced in a beneficiary developing country or in two or more countries belonging to the same association, plus the direct cost of processing operations conducted in such countries, may not total less than 35% of the estimated value of the article at the time it enters United States territory. There are a number of unknowns here, such as the definitions of "estimated value" and of "direct cost of operations", as mentioned earlier.

3. Caribbean Basin Initiative (CBI)

The system used in this scheme is quite similar to that of the GSP, with one important difference: the 35% of national content may include 15 percentage points corresponding to United States content. Direct operating costs may not include profits or overheads but may include the depreciation of machinery and equipment assignable to the product in question.

Annex II of the agreement on rules of origin set forth in the Act of Marrakesh⁴ contains a joint declaration concerning preferential rules of origin; however, this statement makes no contributions of any great significance in its two pages, but instead limits itself to noting the need for such rules to be clearly delineated, for methods of calculation to be transparent, etc. It lays down no guiding principles.

4. Central American Common Market (CACM)

In the case of the signatories of the General Treaty on Central American Economic Integration, the Regulations on Central American Origin of Merchandise are quite permissive. Unlike other free trade areas in the Americas, the CACM is actually a customs union. According to its regulations, the following types of articles are classified as originating goods: i) products "natural" to any member State; ii) goods made from them; iii) merchandise containing imported inputs that has undergone a production process which endows it with an identity of its own, such as to lead to

a change in its tariff classification (the type of change is not defined); iv) in cases where the above guidelines are not sufficient, the standard to be used is a regional content of not less than 25% in direct costs. Products that have merely been assembled, packaged, diluted, etc. are expressly excluded from the above definition. In 1995 a new set of regulations have been under discussion which would make changes in tariff classification the pivotal criterion for determining if a substantial transformation has taken place. Nevertheless, the minimum regional-content requirement remains a controversial issue.

5. Latin American Integration Association (ALADI)

The signatories of the Montevideo Treaty of 1980 have a somewhat more detailed set of rules of origin. Products qualify as originating goods if: i) they have been produced entirely within the country; ii) their tariff classification has changed; iii) the CIF value of materials originating in third-party countries does not exceed 50% of the FOB export value of the merchandise; iv) the goods meet other specific requirements, such as using inputs from signatory countries. The economic complementarity agreement signed by Chile and Mexico in September 1991 expressly recognizes the ALADI rules of origin, although it does permit the Administrative Commission to lay down specific requirements and, indeed, entrusts it with that task. The standards applied by MERCOSUR are similar to those of ALADI.

6. United States

Before it signed a free trade agreement with Canada in 1989, the United States had not published any rules of origin whatsoever, except the more general ones applying to the GSP, the Caribbean Basin Initiative, and the free trade agreement with Israel. Whenever a problem arose, customs officials would refer to general principles which had been developed over a period of many years, in order to take the necessary decisions on a case-by-case basis. It was not until it began to sign major trade agreements with other countries that, for the first time ever, the United States had to address the issue raised by the need for bilaterality in such rules (both as an exporter and as an importer). In the United States agreement with Canada, the criterion was a change in tariff classifi-

⁴ This Act incorporates the results of the Uruguay Round of Multilateral Trade Negotiations (April 1994).

cation or, alternatively, a 50% national value-added requirement, although this standard's definition was somewhat unclear and quite abstract in nature. In its

agreement with Israel, it applied a criterion similar to that used in the GSP, with the difference that it applied to both sides.

IV

Rules of origin in the North American Free Trade Agreement (NAFTA)

1. General definitions

The NAFTA rules of origin are defined and explained in the 26 pages of Chapter Four, volume 1 of the treaty. The detailed descriptions of specific changes in tariff classifications, however, are to be found in 168 pages of volume 2. The general definition is that a good is deemed to have originated in the territory of a contracting party when:

i) The good is wholly obtained or produced in the territory of one or more of the Parties (minerals, plants, stock breeding and husbandry, hunting and fishing, etc.).

ii) All the non-originating materials used in the production of the good undergo a change in the applicable tariff classification as described in volume 2 or, in the event that no change in tariff classification is necessary, meet all of the other established requirements.

iii) The good is produced entirely in the territory of one or more of the Parties exclusively from originating materials.⁵

iv) The good is produced entirely in the territory of one or more of the Parties but some of the non-originating parts used in the production of the good do not undergo a change in tariff classification because they have been classified as an assembled good pursuant to the rules of the Harmonized System, or the tariff heading for the good covers both the good itself and its unattached parts. In this case, the following rule is used: the regional value content of the

good must not be less than 60% of the transaction value (FOB) or not less than 50% of the net cost (this choice is made by the exporter, unless this is not applicable for any of a number of reasons, such as the existence of certain types of relationships among the parties).⁶ Products falling under the heading of "apparel" in chapters 61-63 are excluded from this rule.

2. Motor vehicles: requirement for an increasing content of regional value

The negotiations concerning the automotive industry were rather difficult because the United States and Mexico are both quite sensitive to this industry's influence on employment levels and exports. A very large proportion (between 30% and 40%) of the growth in Mexico's exports over the past 10 years has been accounted for by the automotive industry (engines and motor vehicles). The United States insisted that motor vehicles should include the greatest possible percentage of national content in order to qualify as originating goods. Consequently, in addition to any applicable requirement regarding a change in tariff classification, it was decided that, for vehicles subject to the provisions described in paragraph (iv) of section 1 above, and starting with a 50% regional value content as calculated under the net cost method, that value would rise to 56% in 1998 and to 62.5% by 2002 (or 50%, 55% and 60% for other types of vehicles).

⁵ It is important to note that –unlike the CBI, for example– the territories of the three NAFTA signatories are considered as one. Thus, a Mexican factory which uses only Canadian materials is just as eligible as if all its materials originated in Mexico. For the purposes of NAFTA, the concepts of "region" and "country" are interchangeable insofar as they relate to rules of origin.

⁶ There are various circumstances under which the net cost method must be used; motor vehicles are one example. The transaction value method is extremely easy to use when the percentage of national content is determined by subtracting the value of imported materials from the transaction value of the good. The calculations involved when the net cost method is applied are based on the same formula: the net cost is used instead of the transaction value and in this case any sales promotion, marketing, royalties, packing costs, etc. are excluded.

3. The *de minimis* rule

In the real world, there are many cases in which imported inputs are used that do not undergo a change in tariff classification as required by the specific list, but whose impact on the final product is not very significant. A rule is laid down for such cases (article 405) according to which a good may qualify as an originating good if the value of all non-originating materials used in the production of the good that do not undergo a change in the applicable tariff classification is not more than 7% of the transaction value, FOB.^{7,8} As in the case of the value of regional content, the *de minimis* content can be expressed as a percentage of content by volume or weight.

4. Verification of origin

Chapter 5 of NAFTA deals with customs procedures, most of which refer to the Certificate of Origin. One interesting innovation is that the agent who signs the Certificate of Origin and who bears responsibility for it is the exporter, and not the producer, the Government, a chamber of commerce, etc. This simplifies the paperwork involved, thereby reflecting the most recent trends in international trade rules: i) the trader bears full responsibility; ii) statements are accepted as correct unless proved to be otherwise; and iii) infractions of these rules are discouraged because of the violator's high risk of discovery and the harsh penalties imposed upon offenders. Moreover, it has been found that, in practice, the issue of Certificates of Origin by government agencies does not add a sufficient degree of reliability and that if an exporter is caught violating the regulations, he usually claims that the responsibility for those infringements is shared with the authorities of the country of origin, thus creating unnecessary friction between signatory nations.

5. Specific rules and changes in tariff classifications

The specific rules concerning changes in tariff classification are laid down in volume II of the North American Free Trade Agreement. These rules are set

⁷ There is a specific list of goods to which this rule does not apply, including some dairy products, juices, instant coffee and others.

⁸ "Indirect materials" (gasoline, lubricants, etc.) are automatically classified as originating goods.

forth in two columns: the left-hand column shows the tariff heading, subheading or item, while the right-hand column specifies what constitutes an applicable change in tariff classification in each particular case. For some goods, the specification is so simple that it is given only at the four-digit level; in other cases, six digits are used. In the column that identifies applicable changes in tariff classifications, specifications are often given at the eight-digit level.

For example, in chapter 2, "Meat and edible meat offal", the criterion used to determine whether a good qualifies as an originating good is, for all headings, that the material must come from a different chapter. Strictly speaking, this means that although a live animal may be imported from another country, the slaughtering of that animal constitutes a production operation which qualifies it as an originating good.

The rules of origin applying to textiles and clothing provide a good illustration of how arbitrary, in terms of any logical concept of what constitutes "substantial transformation", the negotiation of these rules can be. In the Harmonized System, these goods are covered by chapters 50 through 63, with wearing apparel being included in chapters 61 and 62 and part of 63. NAFTA's general criterion for conferring nationality upon a product is applied "from the yarn on up", although this is defined more or less strictly depending on the protection guideline being used. For example, woollen yarns (HS 51.06) may be made out of imported wool (HS 51.01) but cotton yarns or threads may not be made out of imported cotton (it must come from one of NAFTA's three signatory countries).

From the fabric level on up, yarns and threads must come from the region, with a few exceptions. For example, silk fabrics (heading 50.07) may come from any other heading. Silk thread is under heading 50.04, which means that a change of heading within the same chapter qualifies a product as an originating good. Silk fabrics produced in the countries of the region using imported silk thread are therefore classified as originating goods. The rationale underlying this determination is that, given the fact that the region's output of such fibres is insufficient, nobody has anything to protect.

Garments must be made of fabric produced in the region, thereby bringing the category full circle (see annex 1).

V

Rules of origin as instruments of a new type of protection

Almost by definition, free trade areas entail a bias that is not present in customs unions. In the Latin American tradition (which is swiftly changing), customs unions have been nothing more than free trade areas which use a common tariff for outside countries. It may be helpful to make a distinction among three types of cases.

1. Perfect customs unions

A perfect customs union is one in which the countries belonging to it have a customs system (it does not matter whether it is a common system or not) and have entered into a prior agreement regarding the distribution of the proceeds among the countries concerned.⁹ In such cases, the country and customs administration through which an imported product—whether an input or a final good—enters the union is irrelevant, since once it has entered, it can circulate freely within that union. Rules of origin are therefore entirely unnecessary.

2. Simple customs unions

In a simple customs union, such as any of those existing in Latin America, a product cleared through customs in country XX cannot then be transferred to country YY because the “common” (but not socialized) external tariff has been collected by the Treasury of country XX. The same is true of imported inputs. This is why customs unions in Latin America have regulations concerning product origin or cases in which a good’s origin is in doubt. The basic reason for retaining such provisions has to do entirely with revenue.

⁹ The European Union (EU) has a common customs administration, and all tariff revenues are paid into the Union’s common coffers. The subsequent use of these funds for joint EU programmes is in no way related to their origin. Hence, the origin of merchandise becomes unimportant.

3. Free trade areas

In a free trade area, each nation applies its own tariff to the rest of the world. In such cases, two problems arise:

i) Merchants may try to bring finished goods into the area through the country having the lowest tariffs and then re-export those products within the duty-free zone; and

ii) Producers in countries where inputs are subject to lower tariffs will have a competitive edge over their counterparts in other member countries. Exporters from outside the area may bring their goods into the country at an earlier stage of processing, finish their processing once they have arrived in member country XX, whose tariffs are lower, and then re-ship the products to country YY, which applies higher tariffs to both the finished good and the corresponding intermediate product.

Problems such as the two cited above are avoided through the use of rules of origin. Another instrument for combatting the second type of practice is the elimination of the system of tariff drawbacks on reciprocal trade.

Let us take a moment to consider this last point. If good AA is produced in country XX using input BB, on which the tariff is 10%, and is also produced in country YY, where BB is subject to a 5% tariff, it is a customary international practice and is allowed under GATT (and now by the WTO) for the exporter who sends product AA from country XX to country YY to request a refund of the tariff paid on the input. This is because—generally speaking—a tariff is paid on the exported product in its country of destination.

However, if the two countries are members of a free trade area, then good AA will enter country YY from country XX without paying a tariff, and this puts producers of that same good who are located in country YY at a disadvantage, since they do have to pay tariffs. In a customs union, there can obviously be no system of reciprocal drawbacks; both types of producers pay the same tariff on their inputs and may

thus compete on an equal footing. In a free trade area, however, the situation is not so clear-cut. In our example, one producer pays a 10% tariff on inputs while the other pays a 5% tariff, but both producers can market their final goods in either country without paying tariffs.

Both the North American Free Trade Agreement and the agreement recently concluded between Mexico and Costa Rica, as well as other such agreements for the establishment of free trade areas which are now being negotiated, set deadlines for the elimination of drawbacks in reciprocal trade. The NAFTA deadline for the elimination of this system is 1 January 2001.¹⁰

Thus far, little thought has been given to the fact that, once drawbacks have been eliminated for reciprocal trade between two countries in which a significant volume of the same input is employed, users in the country with the higher tariff will bring strong pressure to bear on their Government to lower that tariff to the level maintained by the other country so that competitors will have a "level playing field". This is a compelling reason for believing that, if the wave of free trade agreements sweeping over Latin America continues, then the region will be moving towards the establishment of a common external tariff, at least on inputs. It is more than likely that this common tariff would tend to move lower due to the individual, unplanned nature of each dispute between private sectors and their governments.

Conventional economic theory on integration refers—for the sake of convenience—solely to tariffs and occasionally to the suppression of quantitative barriers. It is almost taken for granted that all free trade agreements are good, so long as they do not raise tariffs or non-tariff barriers applying to the rest of the world.

Krueger (1993) argues that free trade areas exhibit a significant protectionist bias which is not present in customs unions. The fact that, in these areas, different tariffs are applied to countries outside the region makes it necessary to have rules of origin; by means of these rules, the trade protection of one member country is extended to the other, thereby

raising the possibility of trade diversion. One SELA document goes further, contending that "rules of origin are to a free trade agreement what a common external tariff is to a customs union" (SELA, 1993).

In the study cited above, Krueger also emphasizes that, according to the conventional view of the positive and negative effects of free trade areas, the lower a country's trade barriers are before it signs a free trade agreement, the less trade diversion will be generated in that country. However, once rules of origin enter the picture, the barriers of a country's trading partner will also need to be low in order for it to avoid paying a high cost for integration.

As a corollary to what has been said in the preceding paragraphs, it should be borne in mind that the formation of a free trade area can lead to both trade creation and trade diversion.

When a tariff reduction enables a country to import goods from its trading partner which it used to produce less efficiently (at a higher cost), we say that a trade flow has been created which did not exist before. If prior to integration a country imported a given product from outside the region but, once trade preferences are in place, it obtains that product from a neighbouring country (which produces the good at a higher cost), then a pre-existing trade flow has been diverted. This gives rise to inefficiency, since, overall, the country is paying more for the product it is importing. It is true that the importer will pay less, but this is only because the tariff has been reduced. The important point here is that the country is beginning to obtain its supply of the product from a more expensive, less efficient source.

One way of lessening this inefficiency is to maintain a low tariff level for the rest of the world on products imported from countries belonging to the free trade area. If this is done, then the trading partner's margin of preference will be smaller and the extent of trade diversion will also probably be less, depending on the relevant products' price elasticity. When trade creation outweighs trade diversion, it may be assumed that the country will be better off. If, on the other hand, trade diversion predominates, the country will probably end up worse off.¹¹ This is the traditional assumption in regard to integration strategies.

¹⁰ These provisions, as well as others, are going to affect the *maquiladoras* in Mexico for two reasons: i) because they are going to be able to place more and more—and eventually all—of their output on the internal market if they so desire; and ii) because exemptions on inputs will disappear, since inputs will be imported duty free in any case as from the year 2001 (International Trade Commission, 1994).

¹¹ Meade-type gains in consumption may occur if the effect of lower prices for consumers outweighs the trade diversion effects.

An extreme example may help us to understand all these different situations more fully. A country with a tariff level of zero on all its products prior to the formation of a free trade area would not lose anything at all, since it would continue to obtain its products from the least expensive suppliers while at the same time enjoying greater access to the market of the other country participating in the free trade area. If rules of origin are factored into the equation, however, then a country that had zero tariffs on all its products prior to the creation of a free trade area might have to switch to a different source for its inputs in order to take advantage of its access to the new market.

The important point here is that rules of origin may extend protection to the country producing inputs for its trading partner's market through the application of preferences to the finished good.

During the negotiations leading up to the North American Free Trade Agreement, the United States took the position that rules of origin should be as strict as possible. In Krueger's view (1993), the United States was clearly trying to protect United States producers in the Mexican market by "exporting" its protection even though Mexico's tariff rates are quite low.

Another angle from which we may analyse the economic effects of rules of origin is as follows: an entrepreneur who seeks to avail himself of a trade

preference in order to export goods within the region is actually sharing this preference with the supplier of the inputs he uses within his targeted regional market. This angle went largely unnoticed in the negotiations, but it is highly significant in practical terms. A numerical example may be useful here.

Let us assume that the tariff rate on product AA in country XX is 15% and that the only input used, input BB, is subject to a 7% tariff. Let us also assume that in country YY, this input is neither produced nor is subject to any tariff and that it represents 50% of the total cost. If the tariff on product AA is eliminated, then the margin of preference enjoyed by country YY in country XX will amount to 15 percentage points. If forced to obtain the input in country XX, entrepreneurs will have to pay 7% more (assuming that the tariff accurately measures the nominal level of protection implicit in country XX). Manufacturers located in country YY will have to subtract an additional cost of 3.5 points ($50\% \times 7\%$) from their 15-point preference (or possible markup). Therefore, their margin of preference will amount to 11.5 percentage points.

Obviously, no government expert is capable of drawing such a fine line, using these types of simplified calculations, for all products. It is therefore vital for the private sector to take part, contributing its calculations and its experts, in order to explore all the possible effects of rules of origin.

VI

A final digression regarding the concept of asymmetry

Of all the terms used by trade negotiators, asymmetry has been the hardest one to pin down. During the NAFTA negotiations, use of the word was prohibited. It was not reintroduced again until Mexico's Secretary of Commerce, Jaime Serra Puche, used it in announcing the outcome of those negotiations when he indicated that they had managed to secure asymmetrical treatment favouring Mexico (Serra Puche, 1992).

The Act of Tuxtla Gutiérrez, of 11 January 1991, which served as a frame of reference for trade negotiations between Mexico and the Central American

countries, states that "negotiations on trade liberalization shall take into account the relative differences existing among the participating countries' levels of economic development" (annex to the Act). On 31 March 1992, the Multilateral Framework Agreement for the Trade Liberalization Programme was signed by the Governments of Costa Rica, El Salvador, Guatemala, Honduras, Mexico and Nicaragua. References are also made to "their relative levels of development" in the Act's preambular paragraphs.

However, no clear definition of the concept of asymmetry has been formulated. If we compare the

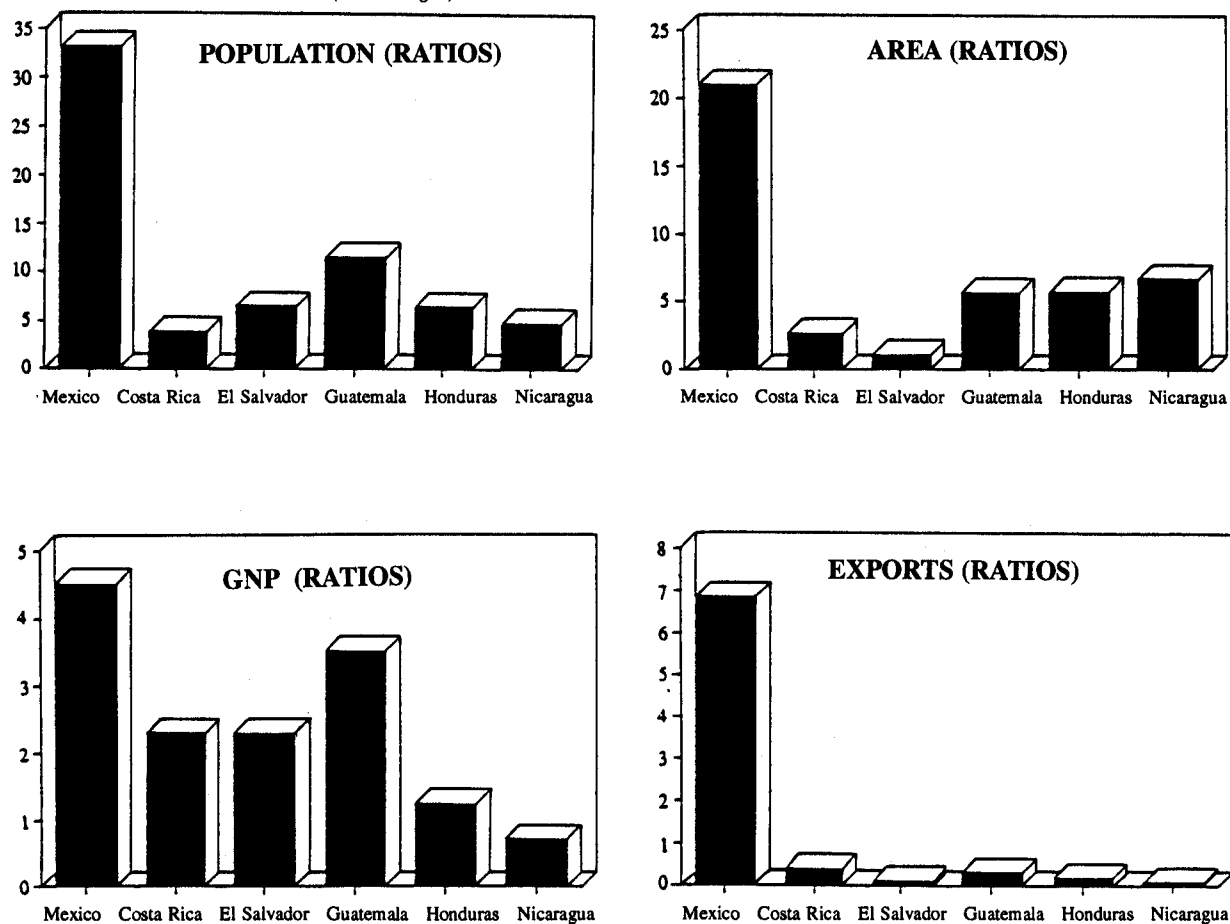
differences between Mexico and the United States in terms of population, gross national product, area and exports with the differences existing between each of the Central American countries and Mexico, and if we regard these differences as indicators of asymmetry, it becomes clear that the distance separating each Central American country from Mexico is greater than the distance separating Mexico from the United States (see figure 1).

The four above-mentioned indicators of relative size should carry their due weight when the countries come to the negotiating table. Generally speaking, negotiators tend to seek asymmetry in the deadlines set for tariff reductions. These deadlines do eventu-

ally arrive, however, and they will finally level off the playing field by bringing trade barriers down to zero. The different amounts of time allowed for countries to adapt to these changes may be important, but rules of origin remain in place and may lead to less efficient future investment patterns. For example, the accumulation of production by small countries for the purpose of satisfying rules of origin may promote regional investment in cases where more than one change in tariff classification is required in order for the final product to qualify. The most typical example is that of wearing apparel, where three changes in tariff classification, starting with the yarn used to make a garment, is usually

FIGURE 1

Central American countries and Mexico: relative sizes
(Percentages)^a



Source: World Bank data.

^a The figures shown for Mexico are expressed as a percentage of those of the United States, and the figures for each Central American country are expressed as a percentage of Mexico's.

required under NAFTA rules. It is unlikely that a small country will have developed capabilities in all three areas (spinning mills, weaving mills and the making up of garments). Therefore, if such a country were to negotiate with Mexico on its own, for example (based on NAFTA rules), it would only be able to export wearing apparel to that country if its production activities were completely integrated or if it acquired its inputs from Mexico. However, if regional accumulation were allowed for these purposes, then Central American investments in textile and spinning mills would be promoted.

Countries that are able to negotiate integration agreements as a bloc will invariably have more opportunities of this type. The possibility of accumulation affords long-term gains, and failure to provide for this approach within short-term organizational schemes may do substantial damage to the smaller economies involved.

In this article we have seen that not only are countries negotiating rules of origin based on different methodologies for measuring what constitutes a substantial transformation (methods which assign differing priorities to changes in tariff classification, the type of change, national added value content, etc.) but even when a methodology is agreed upon, the

rules established for each product differ depending on the outcome of the give and take occurring among the negotiators involved. It is as if, after having—with great difficulty—arrived at an agreement as to whether to use yards or metres in setting the length of the pace to be used by participants in a parade, the organizers had forgotten to decide on the amount of space to be maintained between rows. The result would be disastrous. Yet this may be the direction in which we are heading now.

Cocteau is credited with a well-known saying that, when events overtake us, we should pretend that they were our idea in the first place. If negotiations are undertaken on an individual basis, each country should take into consideration what has previously been negotiated in regard to rules of origin and, just as it will need to measure those rules' impact on the level of protection afforded to its own industrial sector, it should also assess their possible effect on the future location of investments. Given the infinite array of situations that may arise, the system will need to operate on a trial-and-error basis. Emphasis should also be placed, however, on maintaining flexibility in terms of the negotiations' outcome and on the possibility of periodically renegotiating the commitments made.

VII

Conclusions

Just as the issue of non-tariff barriers was in the spotlight during the 1960s and 1970s because these instruments offered a neo-protectionist option for countering the tariff reductions made under the aegis of GATT, and just as possible means of defending a country against dumping come to the fore when an economy is being opened up to external trade, rules of origin have become one of the current issues under discussion in the wave of trade negotiations that has been sweeping over the Americas since the late 1980s. And these rules could prove to have a serious disruptive effect on investment processes as well as markets.

Rules of origin have helped many Latin American countries to make good use of the unilateral advantages granted by industrialized countries, such as those provided under the Generalized System of Preferences and the Caribbean Basin Initiative, and,

to a lesser extent, to comply with the terms of regional free trade agreements or similar types of accords. The plethora of negotiations being undertaken in the light of the new ways in which rules of origin are being used—negotiations in which even the United States will participate—oblige us to take a fresh look at every aspect of the established system.

The application of rules of origin must not be considered in isolation from other measures aimed at rationalizing existing schemes of protection (such as the discontinuation of drawbacks as of the year 2001, which is provided for in a number of treaties to which the United States or Mexico is a party) and evening out barriers to the entry of intermediate inputs.

The rules of origin negotiated in these new treaties make it possible to extend protection regard-

ing intermediate inputs from one country to another. Therefore, the advantages afforded by participation in a free trade area no longer depend so heavily on each country's own system of protection (i.e., on its own tariffs being low), since it has become necessary for its trading partners' barriers to be low as well. Furthermore, the agent gaining access to a trading partner's market must "share the preference" with those benefiting from the relevant rule of origin in the other country.

The smaller the country engaged in negotiations is, the more severely constrained it will be if it accepts restrictive rules of origin. In addition, the "one-on-one" system of negotiations has the serious disadvantage of preventing accumulation for purposes of qualifying under rules of origin. This discourages private investment, whose promotion is precisely one of the objectives of each such treaty. In

view of this situation, there has been a call for joint Latin American negotiations regarding rules of origin. Indeed, determining such rules at the individual country level does not appear to be feasible under existing conditions. As for the general rules, it would be difficult to move beyond what was agreed in the Uruguay Round, which was not a great deal. It would therefore be more meaningful to work on a concept of asymmetry that allows for the recognition that, above and beyond the problem of differing levels of development (which have always served as the context for this concept's use), the relative size of the countries involved is also a factor and that this element gives rise to striking differences in the web of production linkages. It is crucial that progress should be made in this area if private investment is to be promoted.

(Original: Spanish)

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ANNEX 1

**Results of free trade negotiations between Mexico and the United States regarding access for Mexican products.
Example: denim jeans**

Tariff item classification	6203.42.20 6203.42.40B 6204.62.20 6204.62.40B		
Rule of origin	<p>“A change to subheading 6203.41 through 6203.49 [men] or to subheading 6204.61 through 6204.69 [women] from any other chapter, except from headings:</p> <p>51.06 to 51.13: yarns and fabrics of animal hair and wool 52.04 to 52.12: yarns and fabrics of cotton 53.07 to 53.08: yarns of jute and vegetable textile fibres 53.10 to 53.11: fabrics of the above Chapter 54: Man-made yarns and fabrics 55.08 to 55.16: yarns and fabrics of staple fibres 58.01 to 58.02: velvet, felt and terry toweling and fabric 60.01 to 60.02: other fabrics</p> <p>Providing a good has been both cut and sewn or otherwise assembled in the territory of one or more of the Parties”</p> <p><i>Meaning:</i> In order for a pair of trousers to qualify as an originating good, all of its components, starting from the yarn on up, must also be originating goods. These guidelines are complemented, for example, by the rules of origin for cotton fabrics (52.08 to 52.12), which specify that yarns classified under headings 52.05 to 52.06 must be originating goods. In addition, the rules applying to cotton yarn stipulate that the cotton used must itself be an originating good.</p> <p><i>Note:</i> Silk (chapter 50) and linen (53.09) fabrics may be imported.</p>		
Elimination of tariffs on originating goods:	Product	Base tariff rate (%)	Type of reduction
6203.42.20	Overalls (men)	11	A (immediate)
6203.42.40.10	Other denim clothes (men)	17.7	B6 (5 years)
6204.62.20	Overalls (women)	9.5	A (immediate)
6204.62.40.10	Other <i>denim</i> clothes (women)	17.7	B6 (5 years)
Quotas and restrictions	<p>Originating goods are not subject to quotas. Existing restrictions on non-originating goods (at a consultation level of 650,000 dozen) will be discontinued as of 1 January 2001. Products falling under the Special Regime will not be subject to a quota. The definition of <i>maquila</i> processing is broadened to include bleaching, dyeing and washing. Such products are exempt from quotas.</p>		
Special tariffs on non-originating products (cut and sewn in the region)	<p>In appendix 6, all products containing blue denim are listed as exceptions. Consequently, no preferences exist in this case.</p>		

Source: Gitli, 1994.