T20 INDONESIA 2022 THINK

Policy Brief

DISCIPLINING RULES OF ORIGIN AT THE MULTILATERAL LEVEL TOWARDS OPEN AND INCLUSIVE GLOBAL VALUE CHAINS

Task Force 1
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Abstract

Rules of origin are the plumbing of international trade in goods. Yet the absence of multilateral governance on rules of origin generates a regulatory heterogeneity in national policies and practices exacerbating compliance costs in international trade transactions, which in turn substantially reduces the benefits expected from tariff liberalization in Free Trade Agreements (FTAs).

This policy brief recommends setting up a plurilateral agreement governing rules of origin to facilitate the cross-border movement of goods among global value chains and raise the effective utilization of Free Trade Agreements (FTAs).

Challenges

Intergovernmental deliberations at the World Trade Organization (WTO) and former General Agreement on Tariffs and Trade (GATT) 1947 have so far been unable to provide a multilateral agreement to regulate rules of origin (RoO).

Rules of origin are divided into two subcategories:

a) non preferential rules of origin used to regulate application of the Most-Favored-Nation (MFN) duties and WTO agreements and

b) preferential rules of origin used to regulate application of preferential tariffs in Free Trade Agreements (FTAs) and unilateral trade preferences.

Both preferential and non-preferential rules of origin are composed of two aspects. First, the origin criteria determine the nationality of goods according to specific methodologies, such as the ad valorem percentage criterion, the change of tariff classification, or specific working or processing requirement. Second, the proof of origin is the administrative procedure proving the compliance of the good with the origin criteria. The latter can take various forms, such as a certificate of origin, a declaration by the exporter or the importer, or more sophisticated ones (e.g., the registered exporter system of the European Union (EU)).

In spite of decades of negotiations, the built-in agenda for the harmonization of non-preferential rules of origin contained in the WTO Agreement on Rules of Origin (ARO) has never been completed. The harmonization work program stopped in 2007 and there is at present no ambition to resume it.

The failure to reach consensus on disciplining this basic customs law left RoO in a no man's land and has had an unequivocal impact on the international trading system. There is no multilateral framework to regulate the famous "spaghetti bowl" of FTAs exacerbated by the proliferation of different sets of rules of origin among FTAs and lack of transparency in applicable non-preferential rules of origin.

As a result, firms have to comply with multiple sets of rules of origin at product-specific level or PSRO (i.e., at the heading and subheading level of the Harmonized System.[1] This means that an annex to a protocol on rules of origin listing the PSRO may be 60 or more pages long with thousands of PSROs and related certification requirements, varying across-products, export destinations, and across agreements even within a given bilateral relation (e.g., the Regional Comprehensive Economic Partnership (RCEP) vs. the Association of Southeast Asian Nations (ASEAN)-Japan FTAs). While multinational firms are able to maintain compliance software to tackle the complexity of the RoO regulatory environment, SMEs and MSMEs are facing insurmountable obstacles.

In the absence of multilateral governance of Rules of Origin, the continuous expansion of the FTA network worldwide is exacerbating the regulatory heterogeneity, strengthening the non-tariff measures (NTM) character of RoO, and therefore affecting the ability of firms to make use of the agreement, as reported by low utilization rates of various FTAs.

[1] Developed by the WCO, the Harmonized Commodity Description and Coding System, or Harmonized System of tariff nomenclature (HS), is classifying traded products based on a standardized system of names and numbers. It is composed of more than 5,000 commodity groups (6-digit level) and used by more than 200 countries and economies for the application of customs tariffs and collection of international trade statistics. Over 98 % of the merchandise in international trade is classified in terms of the HS (see http://www.wcoomd.org/en/topics/nomenclature/overview/what-is-the-harmonized-system.aspx).

Proposals for G20

This is a critical moment for the international community to take action given the following recent developments:

1. ***Research has detected de facto convergence and lessons learned on rules of origin and their administration***

Research has identified that preferential RoO in FTAs evolved toward simplification and streamlining of the rules of origin. Informed by lessons learned over more than 20 years of operation of major FTAs, governments negotiating product-specific rules of origin in FTAs have been progressively moving towards adopting similar rules (Hoekman and Inama, 2018; Crivelli, Inama, and Pearson 2022) and methodologies (Inama and Crivelli, 2018) in determining origin criteria.

Even more interesting is the comparison of the results that came out of the WTO Harmonization Work Programme (HWP) for non-preferential origin rules with the RoO in these recent FTAs. The latter suggests some progress in simplification and convergence at sectoral level has been observed, despite the unwillingness of some governments to embrace the results of the HWP.

Hoekman and Inama (2018) found evidence of movement toward convergence and simplification of PSROs not only among FTAs but also between FTAs and the HRO: 53% of all tariff lines at the six-digit level show a degree of convergence in form and/or substance among FTAs and with the HRO. Adding to that figure tariff lines where the PRSO is less stringent in the covered FTAs than in the HRO (33% of the total), some 85% of the tariff lines taken together present PSROs that are either convergent and/or liberal.

Mega-regionals in Asia such as RCEP, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), also show convergence with older FTA such as the ASEAN Trade in Goods Agreement (ATIGA) indicating that the trend is expanding. Out of a total of 5,203 PSROs comparatively analyzed among the RCEP, CPTPP, and ATIGA, it has been found that 719 PSROs are identical across the three FTAs and 1,621 PSROs have shown partial convergence, meaning that two FTAs have a similar or identical PSRO, with one FTA having a divergent PSRO. This brings the total of convergent PSROs to 3,109 showing great potential for simplification (Crivelli, Inama, and Pearson 2022).

Obviously, the same research shows that for some sensitive sectors, e.g., clothing and fisheries, substantial divergence in PSROs persists. This should nevertheless not lead to underestimate the gains to be had from such convergence and the scope to codify and enlarge such convergence beyond product-specific rules.

Convergence is also undergoing in administration of rules of origin albeit recent developments call for actions to channel efforts toward genuine trade facilitating initiative and best practices. In this area a number of administrations are moving toward self-certification while others are developing digitization services for proof of origin. While both initiatives are valid steps toward trade facilitation, the WCO Guideline 4 on Certification of Origin (July 2014 - updated in June 2018) and WTO Nairobi Ministerial Decision encourage self–certification with minimum data requirements. There is a need to exchange experiences and identify best practices.

2. *Deliberations at the World Trade Organization (WTO) have resulted in a widely supported proposal to increase transparency on notification of rules of origin*[2]

The lack of consensus on the harmonization work program and the divergent views among the WTO members on how to further proceed on the work on rules of origin brought the CRO to almost a complete standstill in 2013/2014. Some WTO members held the view that concluding the negotiations on the harmonization of non-preferential rules of origin was "no longer a political priority" as "products were now "made in the world" so that the concept of national origin has lost its importance" (WTO, 2013) and that attention should be devoted to preferential rules of origin, certification and verification of origin. Other members were of the opinion that the need for an harmonization work program of non-preferential rules of origin increased given the importance of the application of rules of origin to labeling, trade remedies and government procurement (WTO, 2013).

The stalemate ushered into a different line of work of the CRO focusing on preferential rules of origin for LDCs based on the mandate provided by the WTO Hong Kong Ministerial decision (2005) to ensure that the rules of origin for LDCs are simple and transparent. This new line of work revived the work and deliberation of the CRO and ultimately resulted in the Nairobi Decision on preferential rules of origin for LDCs.

The revival of the work in the CRO on preferential rules of origin inspired a proposal submitted by a group of countries[3] led by Switzerland in 2016 to increase transparency on notifications of non-preferential rules of origin and related procedures. The proposal stemmed from the recognition that most of the notifications of non-preferential rules of origin to the WTO are dating

[2] See "Enhancing Transparency in Non-Preferential Rules of Origin", WTO, G/RO/W/182/Rev.2 of 3 December 2019

[3] As of October 2021, the supporting group included: Australia; Brazil; Canada; Hong Kong, China; Japan; Republic of Korea; New Zealand; Norway; Philippines; Russian Federation; Singapore; Switzerland; the separate customs territory of Taiwan, Penghu, Kinmen and Matsu; and the United States as contained in the WTO document G/RO/W/182/Rev.4 of 13 October 2021.

back to the entry into force of the ARO in the early nineties. The aim of the Swiss proposal is to reduce compliance costs induced by the complexity and divergence of non-preferential origin requirements.

The proposal has received the support of a wide number of WTO members, even from some WTO members that were not ready to accept any further work on non-preferential rules of origin in the CRO.

This is the signal of a significant shift indicating that time has come to mature a new vision and recognize that multilateral action is needed to regulate rules of origin. However, in spite of the limited ambitions of the proposal with respect to the harmonization work program, its growing number of supporters and revisions to take on board suggestions and concerns, the current WTO climate has not permitted to reach the consensus needed for its adoption.

3. An ambitious structured proposal on rules of origin has been presented during the negotiating process of the comprehensive review of the revised Kyoto Convention at the World Customs Organization (WCO).

Annex K of the revised Kyoto Convention on rules of origin is the most complete multilateral text covering rules of origin. It covers not only the criteria and methodologies to determine origin but also administration and verification of proof of origin. In comparison the HWP only aimed at harmonizing non-preferential rules of origin but did not cover preferential rules of origin nor the administration of proof of origin. However, the current text of annex K dates back to the seventies and has now become obsolete.

The current updating process of the revised Kyoto Convention toward the simplification and harmonization of Customs procedures at WCO provides a unique opportunity to revise Annex K on rules of origin.

During this process a proposal has been made by a Sponsoring Group of countries[4] on updating Annex K on rules of origin at the Comprehensive review of RKC. The proposal contains a comprehensive structured document covering all aspects related to non-preferential and preferential rules of origin including certification procedures, administration and verification. Building upon the previous multilateral attempts of governing rules of origin at WTO and WCO,

[4] The Sponsoring Group of the proposal for Annex K on rules of origin during the ongoing comprehensive review of the Revised Kyoto convention is composed as follows: China, European Union, Japan, New Zealand, Norway, Switzerland, the United Nations Conference on Trade and Development (UNCTAD), Eurasian Economic Community (EEC), Renault Nissan, Fonterra.

and on relevant literature and research, the proposal does not provide for harmonization of rules of origin.

Rather, its overall objective is to provide the international community with a "toolbox", including a set of clear concepts, standards, recommended practices and guidelines, leaving the necessary space to policy makers to establish their origin rules and procedures using a "common language and meaning" easily understandable and applicable by customs, firms, other competent authorities and stakeholders.

However, as the process is carried out as part of the overall revision of the revised Kyoto Convention, progress on developing the proposal has been slow in the last two years and it may suffer from lack of political support and visibility to come to a successful conclusion in a reasonable period of time. In addition, not all delegations are supporting the ambitions of reviewing Annex K that originally counted on a limited number of signatories. On the one hand, this may pose certain challenges to the sponsoring group in achieving consensus with the 27 current signatory countries, including Norway, Switzerland, and a majority of developing economies, to adopt a revision of Annex K. However, this may facilitate the process as the revision of Annex K can be adopted by contracting parties independently of the outcome of the comprehensive review of the whole Revised Kyoto Convention.

Developing a multi-track agenda on rules of origin at the multilateral level with timeline for implementation modalities

This policy brief advocates that the G20 economies should become sponsoring members of existing initiatives on rules of origin currently on the table at the WCO and WTO.

More specifically, the G20 should adopt and finalize the proposal of revising Annex K of the Revised Kyoto convention made by the sponsoring group at the WCO no later than the end of 2023. This final proposal should include concepts, standards, and a set of product specific rules of origin where convergence and divergence has been detected as reference tool and best practices in the administration of rules of origin

At the same time, the G20 should announce its intention to launch a plurilateral agreement (PA) under Article II.3 WTO or the so-called critical mass agreements (CMAs) building on the updated Annex K on rules of origin of the revised Kyoto convention.

CMAs are agreements in which negotiated disciplines apply to only a subset of countries, but benefits are extended on a nondiscriminatory (MFN) basis. Examples of CMAs include initiatives such as the Information Technology Agreement (ITA).

Such combined action in WCO and WTO will fill a conspicuous gap in customs legislation at the international level and will parallel what has been achieved for Customs Valuation where WCO

and WTO have joined forces to provide the international trading community with a set of rules and related tools and capacity building initiatives.

On the one hand, the resulting Annex K on rules of origin will provide a set of complete concepts, standards, and best practices including guidelines and options in drafting rules of origin and their administrative procedures in light of best practices and trade facilitating procedures. On the other hand, the plurilateral WTO agreement on rules of origin will be open to remaining WTO members to form a core binding set of rules of origin principles and practices and administrative procedures. Both agreements will contain implementation provisions including transitional periods and special and differential treatment for developing countries and LDCs to implement commitments and introduce the necessary reforms.

The implementation schedule of the commitments contained in these plurilateral agreements should be modeled according to the listing of categories (A,B, and C) used under the WTO Trade Facilitation Agreement (TFA). Each country will have to carry out a self-assessment of the RoO into force both as preferential and non-preferential indicating a work program to bring their set of RoO in compliance with the disciplines contained in the agreements. For commitments listed under category C, a developing country or LDC may designate a transition period to acquire the necessary implementing capacities through the provision of capacity building assistance under Aid for Trade.

Under the new agreements countries will be requested to progressively bring into conformity their RoO provisions and related administrative procedures while maintaining the necessary policy space and implementing options based on best practices contained in the agreements. Countries will be requested to comply with multilaterally agreed definitions and standards when drafting and implementing their FTA and related administrative procedures. Guidelines and options for possible convergence when drafting or reforming PSROs contained in the FTAs will be made available as a toolbox contained in annexes to the agreements that will be periodically updated.

Support the development of FTA and Rules of Origin monitoring tool

Negotiating, signing, and implementing trade agreement might be long and costly. It is therefore crucial to ensure a return on the efforts and resources invested. Simple and transparent rules of origin are instrumental in addressing impediments to the efficiency of regional and global value chains, facilitating goods' cross-border trade, reducing cost of compliance, and fostering utilization of existing and future FTAs. Compliance with rules of origin is *a "conditio sine qua non"* in determining the application of preferential tariffs under any FTAs.

As member countries of G20 are signatories of multiple FTAs, the G20 stands to significantly gain from imparting not only the governance to rules of origin but monitoring their performances.

At the time of importation, goods may be denied the preferential treatment despite their eligibility based on the coverage of the agreement. In such cases, the MFN tariff rate will be levied. Non-compliance with rules of origin and/or related administrative procedures is one of the major causes of such a situation leading to a significant amount of paid duties.

Based on customs data, the utilization rate measures the share of imports effectively receiving the preferential treatment at the time of customs clearance in the preference-giving country out of the amount of dutiable imports eligible for preferences. Research has found that the utilization rates, accompanied by a rigorous analysis, is a valid tool to identify and diagnose cases where rules of origin and/or related administrative procedures cause a net cost to firms and therefore need to be reformed (Crivelli and Inama 2021a, 2021b; Crivelli, Inama and Kasteng, 2021; Inama 2022; Crivelli, Inama and Ha, 2022). Utilization rates have recently gained traction in the WTO CRO as it is now collected by the Secretariat in the context of Duty-Free Quota-Free Market Access for LDCs. However, a systematic collection and report of utilization rates in FTAs is yet to be established.

The G20 should therefore consider the establishment of consultative and intergovernmental mechanisms on utilization rates and related analysis, as built-in provisions of the above-mentioned plurilateral agreements. Such a mechanism would allow early diagnosis of conditions where utilization rates could be improved through trade facilitating rules of origin reforms.

Rules of origin to promote global value chains

Providing governance to rules of origin is a concrete step toward strengthening and galvanizing global value chains facilitating trade and offering more predictability to firms and investors.

The successful conclusion of a plurilateral agreement on rules of origin reflecting new realities of global value chains while considering productive capacities constraints of developing economies will therefore provide a robust basis for a global and inclusive economic recovery. This is an achievable objective within the realm of G20 countries that could provide the decisive policy impetus that has been lacking thus far.

The comparative advantage of G20 resides in its decisive political will that could be imparted to a) finalize and coordinate existing initiatives in WCO and WTO, and b) impart the dynamism and technical support in WTO and WCO to ensure that a critical mass of countries are part of plurilateral agreements on rules of origin that are hosted and successfully administered, stimulating further action-oriented research.

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