Untangling the Noodle Bowl in East Asia: Progress in de facto Convergence of Rules of Origin

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[Introduction]

Good afternoon and thank you very much for inviting me to participate in this conference. In recent years, our East Asian region has been among the most active world regions in the negotiation and implementation of regional trade agreements. A large proportion of these agreements involve ASEAN or individual ASEAN member states and as such there is a certain amount of overlap in the coverage of the RTAs. Anti-RTA academic economists like to seize on these overlapping agreements as the basis for their claims that the resulting divergences in rules of origin creates a “spaghetti bowl” (or noodle bowl”) of confusing rules where businesses find administrative and transaction costs to be so high as to negate the benefits of preferential access under the agreements. Personally, I think this argument is a “red herring”.

From 2007 through mid-2009, I served as the representative of Australia on the Track Two Study Group evaluating the prospects for a Comprehensive Economic Partnership in East Asia or “CEPEA”.

In the report which our Study Group issued last July, we looked at CEPEA through a variety of lenses, including regional cooperation initiatives, facilitation of trade and economic linkages, the potential for further liberalization and institutional initiatives in the region. The issue of rules of origin featured importantly in our report’s discussion of facilitation. In the Executive Summary of our report, we said:

“Rules of origin (ROO) issues are widely recognized as critical elements in ensuring that the gains from economic integration are not undermined by complex rules. At present, each FTA/EPA in the EAS region has varying ROOs, which potentially leads to the “spaghetti bowl” phenomenon. While it was recognized that ROO can be used as a development tool, it was unanimously agreed that well-coordinated and streamlined ROO regimes would be in the interest of business enterprises in the EAS region. CEPEA could be the vehicle for pursuing harmonization and streamlining of the ROO regimes. As an initial step, work on ROO could focus on harmonization of procedures for the issuance of Certificates of Origin and for “self-certification”, and enhancing cumulation rules for effective utilization of FTA/EPAs that can contribute to the expansion of intra-regional trade among the EAS countries.”

More recently, I was involved in the preparation for the ASEAN Secretariat of a “Primer on Rules of Origin” in connection with the implementation of the new ASEAN – Australia – New Zealand Free Trade Area, AANZFTA. While the primer focussed mainly on the operation of the AANZFTA ROOs, we also included comparisons of the AANZFTA rules with those applying in other RTAs to which ASEAN is a party. The comparison chart compares ROOS in AANZFTA with those in the ASEAN Trade in Goods Agreement (ATIGA), the ASEAN-Japan Comprehensive Economic Partnership Agreement, the ASEAN-Korea Trade in Goods

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Agreement, the ASEAN-India Trade in Goods Agreement and the ASEAN-China Trade in Goods Agreement.

What that chart shows, and part of what I am going to talk about today, is that there is actually considerable convergence of the different agreements’ general rules of origin. In practice, there is also some convergence in the product-specific ROOs. And I will come back to this later.

So, it seems that here in East Asia we have been making progress toward untangling the “noodle bowl”. The job we envisaged in the CEPEA Study Group is by no means finished, but a good start has been made. This is good news for those of us participating in this workshop and it is good news for the business communities in East Asia that seek to benefit from the liberalized trading environment of East Asia’s RTAs.

**Progress in Convergence on General Rules**

In this portion of my presentation, I will be discussing the progress in convergence on general rules for ROO in our region through a comparison of the ROO regime in ATIGA with those of the other five agreements I referred to a moment ago.

What you will quickly appreciate, I think, is that not only are the general ROOs – with some exceptions – very similar across agreements but also that the general rule has been designed to be “business-friendly” in an effort to enhance exporters’ ability to take advantage of the agreements.

**[SLIDE 2 – Co-equal Approach]**

A first business-friendly aspect to the ATIGA ROOs is the co-equal approach which mandates that each ASEAN member state must permit the exporters of the good in question to decide which of two possible general rules of origin they elect to meet to take advantage of the RTA. The co-equal approach allows exporters to decide between a ROO stipulating regional value content (RVC) of not less than forty percent or a change in tariff classification approach at the four-digit level of the harmonized system (i.e., a change in tariff heading).

Clearly, this co-equal approach is highly desirable as different exporters who might have very different production networks and supply chains will have the option of choosing the approach which is easiest for them to meet. This should help to increase the utilization rate of the RTA.

**[SLIDE 3 – CTC Restrictiveness Table]**

Not only does ATIGA give the exporter important flexibility in deciding which ROO to meet, but the two general ROOs available are relatively trade-friendly compared to similar ROOs in other trade agreements. For example, the Australian Productivity Commission in 2004 developed a “restrictiveness index” to analyse the extent to which different RTA ROOs made it easier or more difficult for exporters to benefit from the preferential access offered under an RTA. In terms of the CTC rule, the Productivity Commission considered that the ATIGA-type HS four-digit approach is twice as liberal as the two-digit approach that is widely used in some other agreements, like NAFTA.
Having referred to this restrictiveness index, I think some qualifying comments are in order. The problem with the economists who try to boil things down to a level of simplicity which they can use to prepare an index is that the generalizations they come up with are too sweeping. For example, for many manufactured products it might be that a four-digit CTC is less restrictive than a 2-digit change. However, for quite a few chapters of the HS – especially in agriculture – there is no difference in practice between the two rules. It is not difficult or overly restrictive to say that a two-digit change is required to demonstrate substantial transformation when we are talking about the difference between a live chicken and poultry meat.

[SLIDE 4 – RVC Percentage Restrictiveness Table]

The Productivity Commission report gave a restrictiveness score of just 0.40 on a scale of 0.0 to 1.0 to a ROO regime providing for a forty percent level of regional value content, such as the one employed in ATIGA. Here again, I would question the arbitrary nature of Productivity Commission judgments about the degree of restrictiveness associated with the various levels of content. However, it is certainly easier to meet a forty percent content level than one requiring 50 percent RVC.

[SLIDE 5 – Convergence across RTAs]

Now we can see the extent to which we see convergence in East Asian RTAs. Like for ATIGA, the general ROO for three of the other five RTAs is a coequal approach to the use of the RVC forty percent ROO or the Change of Tariff Classification at the four digit level. Only ASEAN’s agreements with India and China take a different approach. However, in the case of the agreement with China, we still see convergence on the RVC side where the same threshold of forty percent is used. The agreement between India and ASEAN is the outlier in the group.

Putting my CEPEA hat back on for a second, I would ask whether it would really be difficult for China to add the option on a co-equal basis of CTC at 4-digit level or for India to consider the more liberalizing approach of the others. It is worth recalling at this point that since there are always going to be a number of product specific rules to deal with cases that can’t fit into the general ROO category; it should be easier still for China and India to join the party.

Cumulation

[SLIDE 6 – Cumulation Approach]

There is no doubt that meeting a particular ROO in a RTA is made easier by provisions that allow for cumulation. Cumulation rules are also particularly important for agreements like those I am focussing on where there are more than two parties involved in the agreement. In the work done by the Australian Productivity Commission, ROOs regimes that provide for the kind of cumulation found in the ATIGA are considered to be considerably less restrictive in their trade impact than those ROOs which do not permit cumulation.

In the ATIGA, we find two rules for cumulation. A general rule permits cumulation across the ATIGA region, provided that each input is originating in any ASEAN member by virtue of satisfying the general CTC or RVC rule. In addition, ATIGA goes further by permitting ASEAN value content of twenty percent or more to be cumulated in direct proportion (on a pro rata basis) to the actual domestic content.
Although none of the other agreements we are comparing here with the ATIGA provide for partial cumulation, all of the agreements converge with the ATIGA approach of permitting cumulation across all members of the agreement where inputs satisfy the applicable general ROOs.

RVC Calculation

The way in which Regional Value Content is calculated is another area where we can examine the extent to which approaches in our six RTAs converge or diverge. This is important in two respects from a business standpoint.

First, in some agreements, exporters are given a choice of calculation methods. Depending upon how they are used to keeping their accounts and keeping track of their inputs, it may be considerably easier to use one calculation approach over the other. Second, to the extent that the calculation methods are the same in different agreements, it helps to facilitate the untangling of the “noodle bowl” syndrome. Exporters do not have to keep learning new methods of proving the same thing.

[SLIDE 7 – RVC Calculation Approaches: build-up v. build-down]

In the ATIGA, participating governments have a choice of specifying one of two classic methods of calculating RVC. They can either specify that traders adhere to the direct formula approach (also known as the build-up method) or they can specify use of the indirect formula (build-down method). ATIGA permits member governments to change the method to the other approach provided they give at least six month’s notice of the change.

This same choice for participating governments obtains in the case of the ASEAN-Korea Trade in Goods Agreement. AANZFTA also allows for use of both the indirect and direct methods, but gives them co-equal status and permits the exporters to make the choice between the two methods.

To a considerable degree we can say there is practical convergence with the other three agreements as well. The agreements between ASEAN and India and China also allow for use of the direct formula approach and for an indirect formula; however, the indirect formula they specify is designed to reveal the extent of non-originating content.

I don’t see that this slight difference in approach should be a major problem for exporters and, in addition, we see convergence in the sense that exporters are given a choice in the methodology to be employed.

ASEAN’s agreement with Japan only permits the use of the build-down (indirect formula) approach – but again, it is the same calculation approach used in ATIGA, AANZFTA and the Korean Agreement.
[SLIDE 8 – Comparison of Calculation Approaches Across RTAs]

**De Minimis Rules**

Where an RTA provides for a ROO based on the CTC approach, additional flexibility is sometimes provided for exporters through the incorporation of a *de minimis* provision.

Under a de minimis provision, goods that do not completely satisfy the change of tariff classification requirement can nevertheless qualify as originating goods, generally where the value of the non-originating goods that did not undergo the required change in tariff classification does not exceed some specified “de minimis” threshold.

[SLIDE 9 – De Minimis Rules]

In the ATIGA, the generally applicable de minimis threshold is set at 10 percent of the FOB value of the good. This general approach also applies in the case of the AANZFTA and in ASEAN’s agreements with Japan and Korea. However, these other three agreements provide for a variation in de minimis treatment in the case of textiles and apparel in HS chapters 50 to 63 where they permit non-CTC qualified content up to 10 percent of the total weight of the product. So, where the RTA ROO permits for the CTC approach in these agreements, there is a fair amount of practical convergence in approaches to the de minimis rule.

The AANZFTA also allows for the de minimis threshold for textiles and apparel to be calculated on the basis of ten percent of the good’s value and the Japan-ASEAN agreement additionally singles out for special treatment goods in HS chapters 18 and 21 (cocoa and preparations and miscellaneous edible preparations) where non-CTC qualified inputs are permitted up to a value threshold of either 7 percent or 10 percent as provided in an annex.

Because ASEAN’s agreements with China and India do not have a CTC ROO, there are no provisions for de minimis flexibility in those agreements.

[SLIDE 10 – Overall Comparison of General Rules]

Now to summarize this portion of my presentation, we can see the considerable progress that has been made in these six agreements toward convergence on the general approach to rules of origin. Five out of the six agreements use an RVC 40 percent rule and four out of six have a change in tariff classification at the four digit HS level as a co-equal approach. All of the RTAs permit cumulation. There is considerable convergence in the permitted approaches to calculation of regional value content and in those RTAs using the CTC approach, the de minimis rules are pretty much aligned. At least in the case of the ATIGA and the agreements with Japan, Korea and Australia/New Zealand, exporters are faced with more or less the same rules across the different agreements. In my view there’s been progress in untangling the noodle bowl in East Asia.
Most regional trade agreements come with pages and pages of product-specific rules of origin and critics sometimes cite these often extensive lists as proof that the negotiators have used special rules of origin to carve out large areas for protectionist treatment. Contrary to this claim, closer observation shows that the product-specific rules are often less restrictive than the general rule and are employed to make the RTA more liberalizing.

For example, in the AANZFTA, there are pages and pages of product-specific rules where the specified rule is RVC(40) or CTSH – a change in tariff classification at the six-digit level. Our friends in the Australian Productivity Commission who developed the ROO restrictiveness index I’ve cited earlier, consider that a change in tariff classification at the six digit level is only two-fifths as restrictive as a change at the four-digit level.

So – bearing in mind the qualifying comments I made earlier about indices and rules of origin, PSRs can have a liberalizing impact on the RTA’s implementation.

In most cases, a very large number of the product-specific rules associated with an RTA are necessitated by some change to the general RVC or CTC rule. In the AANZFTA, for example, we find many cases of PSRs specifying either RVC(40) or CTSH (more liberalizing) or RVC(40) or CC (less liberalizing). There are also cases where the co-equal approach is abandoned for a simple Change in chapter rule or an RVC rule only. In a number of cases, the PSRs are used to make clear which products (usually agricultural goods) are to be considered as wholly originating.

In the China-ASEAN RTA, which generally relies on the RVC (40) approach, the PSRs are used to introduce the change in tariff classification for some products. 129 six-digit tariff items are listed with the change to a six-digit subheading shown as co-equal to the RVC (40) approach.

Apart from variations on the general RVC or CTC rule, product-specific rules tend to be utilized to introduce some sort of process-based ROO. There is quite a variety of process-related product-specific rules across the RTAs we’re examining today, although different RTAs quite often use the same PSRs as others for specific types of products. I will cite a couple examples of this later on.

Textiles and Apparel

Not surprisingly, there are a number of product specific rules that the ATIGA employs for origin determinations in the case of textiles and apparel products. For example, in the case of overcoats the rule is RVC 40 or a change to the six-digit subheading plus a requirement that the good must be both cut and sewn in the territory of a Member State or a special process rule providing for manufacture through the processes of cutting and assembly of parts into a complete article and incorporating embroidery or embellishment or printing from raw or unbleached fabric or finished fabric. This kind of process rule is common across the RTAs in the textiles area.
In the AANZFTA, for example, the rule for many items of apparel is RVC 40 provided that the good is cut or knit to shape and assembled in one or more of the Parties or a change in tariff heading.

The ATIGA has an entire fifty-page annex devoted to substantial transformation criteria for textiles and apparel products. The annex specifies a number of manufacturing processes that confer origin on textiles and textile products, including, for example, spinning fibre into yarn, cutting fabric into parts and the assembly of those parts into a completed article and printing of fabric, if it is accompanied by any finishing operation which has the effect of rendering the printed good directly usable. The annex also specifies a number of manufacturing processes which – by themselves – are not sufficient to confer origin on textile products, for example, simple combining operations or dyeing or printing of fabrics or yarns.

For fibres or yarns, the ATIGA rule for a large number of products is manufacture through the process of fibre-making (polymerisation, polycondensation and extrusion) spinning, twisting, texturizing or braiding from a blend or any of a number of fibres. For fabric or carpets and other textile floor coverings, the substantial transformation rule of the ATIGA calls for one of a number of manufacturing processes including needle punching, spin bonding, weaving or knitting, crocheting or wadding or dying or printing and finishing. For apparel items – like the overcoats I mentioned earlier - the special process rule provides for manufacture through the processes of cutting and assembly of parts into a complete article and incorporating embroidery or embellishment or printing from raw or unbleached fabric or finished fabric.

In the Korea-ASEAN agreement, there are basically two special product specific rules that apply in the case of textiles and apparel. For products like woven fabrics, there is often a choice of three ROOs: a change to the four digit heading; the RVC 40 rule or printing or dyeing accompanied by at least two preparatory or finishing operations. For an apparel item like overcoats, it is a choice between the RVC 40 rule or a change to the four-digit heading provided that the good is both cut and sewn in the territory of a Party.

The Japan-ASEAN Agreement also contains a number of special process-related PSRs in the textiles and apparel area. In fabrics, a change of tariff heading ROO requires non-originating materials to be spun, dyed or printed entirely in a Party, although there is no required CTH where the material is also woven in one or more of the parties. In the year sector, each of the non-originating materials must be spun entirely in one or more of the Parties. For certain linens and rugs, the non-originating materials must be woven or knitted or crocheted entirely in one or more of the Parties.

This same type of process-oriented PSR applies for certain fabrics listed in the product-specific rules for the AANZFTA. Silk fabrics, for example, need to undergo a change in tariff heading or a change from fabric that is constructed but not further prepared or finished, provided that it is dyed or printed and undergoes at least two subsequent finishing processes in the territory of one of more of the Parties to render it directly usable. In the AANZFTA, a product like blankets needs to have a change in HS chapter, provided that where the starting material is fabric, the fabric is raw or unbleached fabric and fully finished in one or more of the Parties.
The rough convergence that exists across the RTAs in the case of product specific rules for textiles products can be illustrated with an example: For HS 5007.20, “Other woven fabrics of silk or silk waste, the product does not need to undergo a change in tariff classification if:

For the Japan-ASEAN agreement: it is dyed or printed entirely and woven entirely in one of the parties

For ATIGA: it undergoes substantial transformation through:
- Needle punching
- Weaving or knitting
- Crocheting or wadding or tufting, or
- Dyeing or printing.

Or where the fabric is in a raw state it must be dyed or printed and then

For AANZFTA: it undergoes two sub-finishing processes

For Korea-ASEAN: it undergoes two preparatory or finishing operations

Because PSRs are so extensively used for textiles and apparel, I think a short summary of the different ROOs is in order at this stage. Basically, we can say that for apparel items, process-related ROOs where they apply, generally specify cutting to shape and assembly into a final good. For yarns and fibres, the PSR generally calls for a process of spinning, twisting or texturizing. For fabrics, the PSR most often specifies a manufacturing process requiring two preparatory or finishing operations.

**Process-related PSRs in Other Areas:**

Apart from textiles and apparel, there are other areas where the RTAs tend to contain process-related product-specific rules.

Now, to start again with the ATIGA, we see that for goods in HS chapter 15 – animal and vegetable fats and oils – it is often the case that no change in tariff classification is required provided that the good is produced by refining. In the AANZFTA we find the same PSR applied to most oils in chapter 15.

For a number of waste products in chapters 25 and 26, the ATIGA PSR is a wholly obtained or produced rule. In the AANZFTA, we find a similar – albeit slightly different - approach where origin is conferred by the waste good being derived from production or consumption in a Party.

AANZFTA contains a special chemical reaction test for certain types of chemicals. The inorganic chemicals classified in HS chapter 28 and the organic chemicals classified in HS chapter 29 may fail to satisfy the RVC or CTC rules provided in AANZFTA Annex 2.

In such cases, the chemicals are considered to be originating if the chemical is a product of a chemical reaction that occurred in a Party. A “chemical reaction” is a process (including a biochemical process) which results in a molecule with a new structure by breaking
intramolecular bonds and by forming new intramolecular bonds, or by altering the spatial arrangement of the molecule. The following are not considered to be chemical reactions for the purposes of determining whether a product is an originating good:

(a) dissolving in water or other solvents;
(b) the elimination of solvents, including solvent water; or
(c) the addition or elimination of water of crystallization.

Another PSR provides that for certain insecticides, fungicides and similar products, the AANZFTA rule is RVC (40) or CTSH, provided that at least 50 percent by weight of the active ingredient or ingredients is originating. This rule reflects concern that a straightforward CTC rule would not guarantee substantial transformation given that simple mixing and adding water might produce the finished good since the materials for producing the good all come from another chapter.

Two other special PSRs found in the AANZFTA concern magnetic and optical media and electro-diagnostic apparatus. In the case of the media, the general ROO is supplemented by a PSR specifying that recording sound or other similarly recorded phenomena onto blank or unrecorded media confers origin whether or not there has been a change in tariff classification.

In the case of the electro-diagnostic apparatus, the general rule is supplemented by a ROO which says that no change in tariff subheading is required provided that the machines, apparatus and instruments are manufactured from parts produced solely for the machines, instruments or apparatus of the same subheading.

[SLIDE 14 – OCPs]

Operational Certification Procedures

One last – and important – area that we should spend a bit of time on today concerns the operational certification procedures governing the ROOs in the various agreements we are discussing. Although there is not complete harmonization of the OCPs, we can see convergence in many areas of ROOs administration.

In ATIGA and in all of the other five RTAs, it is envisaged that the exporter should generally request a pre-export examination as a basis for developing information supporting evidence of origin.

The nature of the certificates of origin required under the agreements is very similar. In the ATIGA, AANZFTA, Japan and Korea agreements, the certificate consists of an original plus two copies, with a unique certificate number, specified minimum data requirements and an official seal of the issuing body. In the agreements with China and India, there must be three copies in addition to the original. Except for the agreements with Korea and China, the certificates are valid for twelve months and in the case of all of the agreements, they can be issued retroactively if need be up to twelve months after original issuance.

In all of the agreements except for the ASEAN agreement with India, no certificate or origin is required in the case of goods with an FOB value of less than US$ 200.
Back-to-back certificates are required in transhipment cases, except for the agreement with China, where no such provision exists.

Finally, all of the agreements provide for the possibility of after the fact verification procedures where considered necessary and impose record-keeping requirements on exporters, importers and the issuing body. Except for the agreements with India and China, where the requirement is for a shorter period of time, records generally have to be retained for a period of three years.

[SLIDE 15 – Convergence and Divergence]

**Summing Up**

I am the first to admit that rules of origin are not the most exciting topic for an afternoon discussion. They are, however, important to business and countries that are active in the negotiation of regional trade agreements have an obligation to make the ROOs workable and as easy as possible for business to make practical use of. None of us here in this workshop has an interest in further tangling the “noodle bowl”.

So how might I sum up this overview of rules of origin in East Asian regional trade agreements?

As I said earlier, we can see the considerable progress that has been made in these six agreements toward convergence on the general approach to rules of origin.

Five out of the six agreements use an RVC 40 percent rule and four out of six have a change in tariff classification at the four digit HS level as a co-equal approach. All of the RTAs permit cumulation. There is considerable convergence in the permitted approaches to calculation of regional value content and in those RTAs using the CTC approach, the de minimis rules are pretty much aligned.

At least in the case of the ATIGA and the agreements with Japan, Korea and Australia/New Zealand, exporters are faced with more or less the same rules across the different agreements. In my view, there’s been important progress in untangling the noodle bowl in East Asia.

We can also see a considerable degree of convergence in East Asia in the administrative aspects of ROOs in the operational certification procedures.

Where we see the greatest degree of divergence in approaches is in the process-related product-specific rules. A large number of these (as a percentage) in all of our agreements affect trade in textiles and apparel where frequently the PSRs introduce a process-related test. The potential for complication is mitigated to some extent by the fact that in textiles and apparel, a number of the process tests for particular products are similar across agreements. So if you are an exporter of these products, you can probably get to understand the rules and how they apply to the manufacturing process pretty easily.

Finally, there are a large number of cases where we can see that the intent of the PSRs is to make the implementation of the agreement less restrictive than would be the case under the generally applicable ROOs regime.
This appears to be the case in the chemical reaction test, the refining rule for edible oils and those PSRs that use the six-digit CTSH rule in place of the normal 4-digit CTC approach.

[SLIDE 16 – Title of Presentation]

At the beginning of my remarks, I referred to my experience with the CEPEA Study Group and our recommendations with respect to rule of origin. I think what my presentation shows is that while there is scope for further harmonization and convergence on ROOs in East Asia, we have come a long way and the current situation is very promising. The important progress that has been made augurs well for regional coherence and economic integration.

I hope that I have been able to make a contribution to your discussions. Thank you for your attention.

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