

FTAs trip business on rules-of-origin



Geoff Short*

Managing Director,
Tanda International Pty Ltd

FREE TRADE agreements and the Rules of Origin within them are a fact of life, and smart international traders must commit resources to come to grips with this new challenge. They must understand the bi-lateral agreements relevant to their trading operations to maximise the benefits of reduced tariff and non-tariff barriers. And they must keep a broader watching brief on bi-lateral and regional agreements to reduce the threats to their business from better deals being negotiated with competing marketplaces . . .

SYDNEY – You run a manufacturing and exporting business in Asia. Your product range covers 50 different tariff headings. You export to 15 countries. You know there are Free Trade Agreements in the region that provide duty-free entry to some of these markets. *At last! The Utopia of free trade has arrived!*

Perhaps not. It can be tricky. Problems are created by the growing number of trade agreements, the fact that each agreement has its own rules of origin – and that those rules are increasingly complex.

Which countries have these FTAs? There are currently almost 30 FTAs in force in Asia, with a similar number currently under active negotiation. In a few short years, there could be 70 or more, dealing with intra-Asian trade and trade between Asia and other regions. So you need to work out which of your target markets offer these trade benefits now, and which might come on-stream in a year or two.

Start researching!

But, you say, at least they all follow the same approach, right? Not exactly. They come in many shapes and sizes – so-called “Free” Trade Agreements, Preferential Trade Agreements, Closer Economic Trade Agreements, Comprehensive Economic Co-operation Agreements, Closer Economic Partnership Agreements and many others. Each is unique.

Each has its own objectives, ranging from a simple “early harvest” of tariff reductions on a limited number of “non-sensitive” products to comprehensive agreements dealing with tariffs, services, investment, business migration and behind-the-border issues like intellectual property protection.

OK, but at least if I can show that my goods qualify for preferential treatment under one FTA, they will qualify under the other FTAs as well. Wrong!

Rules of Origin are rules written into trade agreements to ensure that only “originating goods” of the countries which are parties to the agreement obtain the benefit of preferential tariffs. This is normally quite clear for products that are wholly-produced in one country. The World Customs Organisation’s *Kyoto Convention on the Simplification and Harmonisation of Customs Procedures* provides a list of such goods – such as minerals extracted, crops grown and harvested, and animals born and raised in a particular country. Many bilateral agreements adopt this list.

Complications arise, however, in the common situation where the goods to be exported are produced from raw materials, ingredients, components or intermediate goods from other countries. The Kyoto Convention provides guidance on establishing the origin of goods in these circumstances. It recommends the “*Substantial Transformation*” test, under which the country of origin is the country where the last substantial manufacturing or processing – which gives the commodity its essential character – has been carried out. Some trade agreements define substantial transformation by reference to a change of tariff classification – if the finished product has a different tariff classification from its component parts, then the parts have been substantially transformed. Some agreements rely on a “regional value” or “local content” test – a certain percentage of the value of the finished product must be added in the country of export (or other countries which are parties to the agreement) if the goods are to be considered to originate there. Some agreements do both.

The problem for traders is that each trade agreement has its own rules of origin, rules that are increasingly complex. Some examples will illustrate the difficulty.

AFTA (the ASEAN Free Trade Area) imposes a 40 per cent local content rule. The Australia-Thailand FTA imposes a regional value content requirement for *some* goods – but the rate varies from 40 per cent to 45 per cent to 55 per cent, depending on the goods. The Australia-United States FTA also imposes a regional value content test, but introduces a “build-down method”, where the threshold is 45 per cent, and a “build-up method”, where the threshold is 35 per cent. In respect of some automotive goods, the threshold is 50 per cent.

The Australia-Thailand and Australia-US agreements, however, also rely on a change of

tariff classification test for other goods – but for some it is sufficient to change from one tariff subheading to another, while, for others, it requires a change of tariff heading or tariff chapter. For yet other goods, a change from certain specific tariff headings is expressly precluded from qualifying. For some goods, it is necessary to meet both the regional value content and change of tariff classification tests.

As a trader in goods covered by 50 different tariff classifications, you have to inquire separately as to which specific rule applies to each of your products. **The answers generally lie in annexes to the agreements.** In the case of the Australia-Thailand agreement, the annex providing the product-specific rules stretches to 281 pages. These variations are multiplied across the almost 30 different agreements currently in place.

As a manufacturer/exporter, at least you have access to the necessary information to determine how much value has been added to the product in your factory, and to understand which inputs have gone into the product, which countries they came from and what their respective tariff classifications were.

Now change hats and assume you are an importer of the finished product in one of your export markets – that is, the person who will actually pay the customs duty if the goods do not qualify for preferential treatment under a trade agreement. Assume also that, after manufacture, the goods pass through a distributor before reaching the exporter who sells them to you, the importer. Neither the distributor nor the exporter has access to the information required to satisfy the local content or change of tariff classification tests.

You may not have any relationship with the manufacturer. Even if you do, how would you propose to persuade that manufacturer to disclose his costings in order to prove compliance with the local content test? How would you propose to persuade him to catalogue the inputs to his manufacturing process along with their countries of origin and respective tariff classifications? Having sold the products to the distributor, the manufacturer is unlikely to have any commercial interest in answering your impertinent inquiries.

Rules of origin, no matter how elegant or logical they may seem in theory, present great difficulties to traders in practice. A further variable that needs to be managed by traders is the type of evidence required to support a preference claim – that is, to prove that the goods are originating goods. Under AFTA and the Australia-Thailand FTA, a Certificate of Origin is required. Under the Australia-United States FTA, however, no Certificate of Origin is mandated – but importers are obliged to maintain evidence, in an unspecified format, to prove compliance



with the specific rule(s) of origin applying to their goods in case it is requested by Customs.

These variations and complexities in the rules of origin under the many trade agreements in the region tend to undermine the effectiveness of the agreements, particularly for traders with a large range of products operating in numerous countries. There are known instances of multinational companies, with annual customs duty costs of millions of dollars, struggling to assess which of their products qualify for preferential treatment and to assemble the necessary supporting evidence, even 18 months after commencement of the relevant trade agreement.

Where the non-preferential tariffs are relatively low, many importers simply decide that the cost and effort involved in claiming the preference outweighs the potential benefit of reduced duties – especially where the market has already factored in the duty cost. This tendency is reinforced in countries where Customs regulators impose significant penalties for incorrect preference claims. These failures greatly diminish the claimed benefits of bilateral and regional trade agreements.

For these trade agreements to truly “liberalise and facilitate” trade, more efficient ways will need to be designed to identify originating goods.

One of the most significant challenges facing trade agreement negotiators is to adopt a uniform approach to rules of origin, an approach that works as well in practice as it does on paper. This will go a long way to making the current “noodle bowl” of agreements more digestible.

Clearly, it is in the interests of traders to make this happen. You are not powerless victims of the negotiation process. Negotiators cannot act in your interests without practical input from traders and manufacturers. Individual companies, industry associations and bi-lateral chambers of commerce should all be actively pressing negotiators to find simpler, more uniform rules of origin that will allow you to access the full benefits of these trade agreements.

* *Tanda International Pty Ltd provides trade regulation advocacy services to manufacturing and import/export companies in the Asian region. www.tanda.com.au*



This report appears in
ASIA2007, published by **ASIA
TODAY INTERNATIONAL
Magazine** in October 2006.