

Creating development friendly Rules of Origin in the EU

The EU Commission argues that radical changes to the origin rules will both simplify processes and make them more development friendly. Will they?

Key points

- This apparently dry topic is actually critical in determining the impact of rich-country trade policies on developing countries.
- There are different opinions on what Rules of Origin should achieve – which complicates the task of setting the right level.
- A substantial recent ODI study provides benchmarks against which to judge the proposals when they emerge.

Overseas Development Institute

ODI is the UK's leading independent think-tank on international development and humanitarian issues.

A country uses its Rules of Origin (ROO) to establish where a good is produced and therefore what tax is paid (or other rules applied) when it is imported. They are the 'small print' of trade preference and regional trade agreements – any favourable treatment that they promise applies only to goods that meet the rules. Changing the rules will change the benefits. This Briefing Paper is about the EU Commission's proposal for a radical change to its rules.

The Commission argues that the changes will both simplify processes and make the rules more development friendly (see Box 1). Will they? What are the opportunities and pitfalls? The Briefing Paper supplies evidence from a substantial ODI study.¹

In a world in which all trade partners were treated equally there would be very limited need for ROO. But many countries export to the EU and other developed country markets on terms that are more favourable than those available under the WTO's most favoured nation terms (Stevens and Kennan: 2005). Since only some countries are eligible for favourable treatment it becomes a matter of great commercial importance where a good is produced. If an importer claims a preference but the source is later adjudged to have been non-preferred a criminal offence (tax evasion) may have been committed.

So this apparently dry topic is actually critical in determining the impact of rich-country trade policies on developing countries. Take the clas-



A cottage industry loom, Tamil Nadu, India. Is this Indian under EU rules?

sic example of Lesotho: it exports trousers made from Chinese cloth to the USA under the African Growth and Opportunity Act (AGOA) as US origin rules currently accept them as being of Lesotho origin; it cannot profitably export the same trousers to Europe because the EU deems them to be Chinese (and therefore ineligible for the trade preferences that it notionally offers to Lesotho).

Customs authorities have tended to agree that the point of origin of a good is the place at which *the last substantial transformation* took place. How is 'substantial transformation' determined? There are three main approaches and the EU currently combines all of them, often with two or more as alternatives or as dual requirements. They are: **tariff jump** (under which imported inputs are allowed so long as they fall under a different statistical customs code from the final, exported product); **process** (which specifies the work that must be undertaken on any imported

Box 1: The EU Commission proposals

In December 2003 the European Commission presented a Green Book on the revision of the preferential ROO. This formed the start of consultations with the private sector and other stakeholders. On the basis of these the Commission presented, on 16 March 2005, a communication on the future of the ROO. It aims 'to make rules simpler and, where appropriate, more development-friendly' (COM: 2005). A key proposed change is to use a 'value added test' as the starting point. A limited degree of differentiation is foreseen between sectors and in relation to Least Developed Countries (LDCs), but much less than at present (where rules can vary between sub-products).

inputs); and **value added** (under which imported inputs must not exceed a given percentage of the processed good's value).²

What should they achieve?

There are different opinions on what ROO should achieve – which complicates the task of setting the right level. They have one essential task: to avoid 'trade deflection' by ensuring that the goods on which import taxes are reduced or eliminated are the ones intended by the lawmakers. They should prevent firms from a non-preferred state establishing shell companies in a preference-receiving state to import almost fully finished goods and re-export them with minimal processing – solely in order to obtain the tax break. This task can be achieved by ROO set at a level normal for firms in commercial situations.

A second task is frequently added – and is more controversial. It is to stimulate the creation of value in the country receiving the preference by making the preferential tax break available only if firms undertake more processing than is 'commercially normal' (see Box 2).³

This extra task is controversial because it may backfire: by imposing commercially unrealistic demands it may simply prevent trade from occurring (as in the case of Lesotho's non-export of trousers to the EU). Supporters argue that it increases the value of preferences by encouraging industrial development. Critics respond that it undermines preferences by putting them out of reach; some say that this is the implicit, protectionist aim.

Is a 'simple' value-added system feasible?

The Commission proposes to shift to a regime based on value added. In its study ODI has asked two questions:

- how much value do firms normally add on processed and manufactured goods that are exported by poor countries to the EU and which are the ones

for which ROO are relevant?

- are these levels similar between products and countries?

The first question establishes the value-added threshold needed in any new ROO to avoid trade deflection. If the ROO thresholds are set at a higher level, notionally to foster extra industrial development, the answers provide a benchmark against which to judge the plausibility of this claim against the charge of protectionism. The second question establishes the feasibility of the Commission's objective to use the change to simplify the system.

The answers are that typical value added is often very low (much lower than the EU's existing ROO thresholds – see below). It also varies enormously between products and countries casting severe doubt on the feasibility of the Commission goal of a simple, uniform *and* development-friendly system.

The conclusions are derived from an extensive analysis of poor-country exports to the EU and of UNIDO data on value added in these sectors (see Box 3). This has shown that ROO are important for a significant number of poor countries and cover a wide range of products: it is not just the case, for example, that they are of concern only to Bangladesh and India, or just on clothing (see Table 1).

There is substantial variation in typical value added between product groups: from a low of 23% (for meat processing) to a high of 48% (for ceramics). But the variation between countries (poor, medium and rich) in the same sectors is even greater: from a minimum in one sector of 27 percentage points between the countries with the lowest and the highest value added to a maximum of 76 percentage points.

Strikingly, value added is not always lower in poor than in rich countries. In some cases the highest value added recorded in an ISIC group was by a least developed country (LDC). Some EU members have lower levels than developing countries are required to reach to satisfy the ROO! An interesting question is whether the ROO are forcing poor countries into an old fashioned industrial structure that will be untenable if the preferences are eroded or removed.

Because of this variation any single threshold would be too high for some sectors and exporting states, and too low for others – hence the apparent infeasibility of creating a new system that is both simple and development friendly. It can be 'simple' only if thresholds are set far too high for many or unnecessarily low for others. The former would make the new rules more development unfriendly than the current ones.

What is the appropriate level?

Despite the variation, the study was able to identify benchmarks for the appropriate level of value added by firms to establish originating status. This is important for judging the thresholds that the Commission eventually proposes, and also the development friendliness of the existing rules (next section).

Table 2 shows the mean value added recorded for

Box 2: The consequences of higher-level ROO

ROO that require a higher level of processing than is commercially normal for an individual firm can be achieved in one or more of three ways: the exported product can incorporate domestically produced raw materials; or it can use domestically produced intermediate inputs; or the exporting firm can invest to undertake more processes than are the norm. A consequence is that ROO set at a higher level will restrict the availability in practice of trade preferences that exist on paper to goods which incorporate domestic raw materials, or to countries that have a developed and competitive intermediate goods sector, or to cases where the tax break is sufficiently large to make it commercially feasible for a firm to undertake processes that otherwise it would not perform.

This will tend to mean that poorer countries (with a small manufacturing base) are locked into processing raw materials and locked out of the most dynamic global value chains which, typically, involve goods being made in lots of small steps. A standard criticism of the existing EU rules by industry sources, for example, is that they hark back to a bygone form of industrial organisation:

The current rules were drawn up at a time when a vertical model of several stages of manufacturing in one country was the norm. Final assembly and/or finishing process are increasingly replacing this model, with multi-country sourced components constituting the overwhelming value of the final product (Cerrex: 2002).

Table 1: Distribution of exporters by product type

Category	# products ^a	# low-income exporters ^b
Processed primary products	1	8
	2	6
	1	5
	1	4
	7	3
	10	2
Narrow manufactures	1	11
	1	10
	1	9
	1	8
	3	7
	4	6
	5	5
	12	4
	21	3
	37	2

Notes: (a) The number of products defined at HS4 level into which CN 8-digit products exported by low-income countries to a value of €5 million or more fall.
 (b) Of items within the respective HS4 heads to a value of €5 million or more.

each ISIC category by all the countries in the sample and by the two poorer groups. Three sets of figures are given because richer countries sometimes have lower value added than poorer ones. To avoid distortions caused by the current rules being replicated in future ones, the new rules should be based on the lowest of the three means. This would imply thresholds for these ISIC groups:

- under 20% in a few cases (down to a low of 14%);
- in the 20–30% range for 14 groups;
- 31–35% for a further 13 groups; and
- over 35% for just five groups.

Are the existing rules too severe?

These figures provide a point of comparison for the value-added figures in the existing rules in the Generalised System of Preferences (GSP) and Cotonou (see right-hand column of Table 2). The comparison is not direct since the current rules establish what must be done within a country; in sectors where several firms are engaged in producing raw materials or intermediate inputs, more than one may be involved in reaching this target. By contrast the figures in Table 2 (cols 2–4) apply only to a single firm.

Comparing the figures shows how much *extra* processing is required in a country beyond the level normal for a single firm. This provides a basis for determining the realism of the targets for poor countries.

The value-added thresholds used in the current rules are much higher than the levels normally achieved by firms. In one-third of ISIC sectors the Cotonou/GSP figures are at least twice the level found of the lowest mean value added in Table 2, and this figure rises to two-thirds in cases where there is a range of Cotonou/GSP values if it is the highest that is taken. There is not a single case in which the

Table 2: Typical value-added levels

ISIC Rev 3 category		Mean VA (%)			GSP/ Cotonou minima (%)
Code	Production/manufacture of	All income groups	Low	Lower-middle	
1511	Meat products	24	21	29	
1513	Fruit/vegetables	30	32	26	60 or 70
1543	Chocolate/confectionary	35	30	29	70
1549	Food products n.e.c.	34	27	32	
1711	Textiles	33	24	38	52.50
1721	Made-up textiles	33	27	32	60
1722	Carpets	36	39	36	60
1730	Knit/crochet fabrics	37	24	38	
1810	Wearing apparel	41	40	40	52.50 or 60
1911	Leather	23	21	23	
1912	Leather articles	44	41	42	
1920	Footwear	36	34	33	
2010	Wood	34	36	33	
2021	Veneer sheets	35	29	39	
2029	Wooden products	39	30	40	
2221	Books	40	37	35	50
2520	Plastics products	33	28	30	50
2610	Glass/glass products	42	34	44	50
2691	Ceramic ware	48	43	44	
2893	Cutlery/hand tools	41	31	37	
2899	Metal products n.e.c.	38	36	38	70
2915	Lifting/handling equipment	36	34	29	60 or 70
2924	Mining equipment	38	38	34	60 or 70
3000	Office/Computing machinery	31	42	34	60
3110	Electric motors	41	56	32	60, 70 or 90
3150	Lighting equipment	40	37	33	50, 60 or 70
3230	TV etc. equipment	32	30	34	60 or 75
3311	Medical equipment	43	32	36	60 or 75
3591	Transport equipment n.e.c.	31	19	43	60
3592	Bicycles	32	14	43	60 or 70
3610	Furniture	36	32	35	51, 60 or 75
3691	Jewellery	35	33	31	
3693	Sports goods	39	32	46	
3699	Other manufacturing	34	27	33	

Sources: calculated from UNIDO data; EU Commissioner's Export Helpdesk for Developing Countries (<http://export-help.cec.eu.int/>)

Cotonou/GSP threshold does not exceed the highest of the three means given in the table, and in only two cases is the difference less than ten percentage points; normally it is much greater. This implies a heavy bias against firms in small economies that do not process domestic raw materials.

A disproportionate change for poor countries

Fortunately, value added is used as the sole test of originating status in Cotonou and the GSP for only one-tenth of the goods that poor countries actually export to the EU and for which origin rules are likely

Box 3: The ODI study

ODI has analysed imports into the EU in 2003 of processed primaries and manufactures exported by low- or lower-middle-income countries for which origin rules could be potentially important. This involved analysing imports from 167 developing countries and classifying as 'ROO relevant' or irrelevant 9,625 separate items (9,065 of them exported by low- or lower-middle-income countries). Any special features of LDCs have been flagged.

This review identified over 30 low-income countries with exports exceeding €5 million in at least one Harmonised System (HS) 4-digit category. Just under one-quarter of processed primaries and one-third of manufactures were exported by four or more low-income states.

These goods were allocated to the relevant category of the (much more aggregated) ISIC industrial classification and data obtained from UNIDO for each of these on firm-level value added that appears to equate broadly with the Commission's definition of value added. Figures for a representative sample of low-, lower- and upper-middle- and high-income states were analysed for the typical value added by commercial firms to provide benchmarks, by sector, for judging the ROO thresholds needed to avoid trade deflection.

to be relevant. In most cases value-added targets in the current rules are an alternative (or a supplement) to a tariff jump (the most frequently used criterion) or process rule.

But this also means that using only a value-added test will represent a major – and disproportionately large – change for countries exporting under Cotonou or the GSP. Value added is already in use more frequently for other countries: in 23.5% of cases across all agreements according to the Commission, making it the second most frequently used sole criterion (EC: 2005).

Yet Cotonou and the GSP are the regimes scheduled by the Commission to be the first for change: it proposes to apply the new system first to the very countries for which it would represent the greatest proportionate change. Unless the new value-added requirements can be met by the processes specified in the current regime and allow very similar imported inputs, there will be a shift (potentially very large) in what is covered or excluded from the GSP and Cotonou preferences. Some existing exports will no longer meet the EU ROO; others may find the opposite – that they can now obtain preferences that were previously denied.

The situation of LDCs

The LDC group is treated differently (and more favourably) in the trade policy of the EU (and other rich countries) than are other developing countries. It may be politically easier to offer flexible ROO to LDCs than to

others. Would it also be developmentally justifiable? Do LDCs share similar characteristics that provide an economic justification for less onerous ROO? The answer from the ODI study is 'no'.

The EU's ROO appear to be unduly onerous, but the adverse effects apply equally to all poor countries; they do not bear especially severely on LDCs. The study has uncovered no evidence that LDCs, as a group, have specific characteristics different from those of other poor countries that would justify special origin rules being incorporated only in the trade regimes that are exclusively for their benefit. The level of value added in LDCs can normally be found anywhere on the spectrum of findings for countries from all income groups: in only 10% of sectors did all LDCs in the sample have similar value added.⁴ In 25% of cases, an LDC recorded the highest value added of any country.

Nor does it appear likely that full cumulation among LDCs will be particularly helpful for them.⁵ There is no evidence in the important sectors that some LDCs export goods that are needed as inputs by others for the production of final goods. So allowing one LDC to use unlimited inputs imported from another LDC would serve no purpose.

There *may* be a political case for special measures just for LDCs, given that they are already treated differentially by many countries. But the ODI study has not been able to uncover any economic reasons to justify not granting similar treatment to non-LDCs.

A watching brief

As the Commission has not yet issued details of the new ROO regime it is premature to conclude that it will not be simpler and more development friendly than the current regime. But the ODI study suggests the need for considerable scepticism. It provides benchmarks against which to judge the proposals when they emerge. A major challenge is to avoid either enormous complexity or thresholds that are too high for some but too low for others. If this hurdle is overcome and the Commission suggests value added thresholds of around 25% or less in many sectors, they could well be development friendly. If they are 35% or more, they are probably unfriendly. And countries exporting under the GSP or Cotonou have reason for great caution.

Written by ODI Research Fellow, Christopher Stevens
(c.stevens@odi.org.uk).



Overseas Development Institute

111 Westminster Bridge Road, London SE1 7JD

Tel: +44 (0)20 7922 0300

Fax: +44 (0)20 7922 0399

Email: publications@odi.org.uk

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Endnotes

1. 'Creating Development Friendly Rules of Origin in the EU'. ODI, November 2006 (www.odi.org.uk/iedg/publications/online_papers.htm). The research was funded by the Netherlands Ministry of Foreign Affairs, Development Cooperation Department, but they are not responsible for the findings or for the views expressed.
2. Technically all of these references to 'imports' should be to 'non-originating inputs' since imports from some sources do not need to be 'substantially transformed'. In the jargon this is called 'cumulation' – under which the processing in one country of a good that is then imported into another as an input into a product that is then exported under preference can be taken into account when calculating the extent of transformation.
3. This is the case 'by definition'. If the level of processing needed

to ensure that the exporting firm is not a shell company is considered to be adequate, there will be no need for any additional requirements. Only in cases where performance of the 'essential task' requires processing that is deemed to be inadequate is there a need for additional requirements.

4. Data on LDCs were available for only 32 of the 34 ISIC groups
5. See Note 2 for a definition of cumulation.

For references see: www.odi.org.uk/publications/briefing/bp_ROO_novo6_refs.pdf

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Overseas Development
Institute

111 Westminster Bridge
Road, London SE1 7JD

Tel: +44 (0)20 7922 0300

Fax: +44 (0)20 7922 0399

Email:
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