Rules of Origin and Trade Diversion: The Case of the Egyptian-European Partnership Agreement

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Introduction:

Preferential rules of origin (ROO) are of crucial importance in the functioning of any free trade area (FTA) in administrating a number of trade issues and in avoiding trade deflection. Despite such importance their design can result in their development as trade protectionist tool hence leading to trade diversion. This study focuses on the design of ROO in the Egyptian- European FTA that has been recently signed. The main aim is to investigate whether the ROO will result in trade diversion or not. Following this introduction, section two follows which provides a short literature review on the role of ROO in FTAs. Section three discusses the different methods utilized in the determinining ROO together with identifying the pros and cons of each of them. Section four reviews the methods adopted by the European Union (EU) in its design of preferential ROO. Section five is mainly confined to the method adopted in designing the ROO in the Egyptian- European FTA. Section six reviews the methods utilized in regional trade agreements (RTAs) worldwide to confer rules of origin. Section seven concludes and provides some policy implications.

2. The Role of ROO in FTAs:

ROO in general serve as important elements in the administration of a range of other trade regulations, including: duty drawback provisions; antidumping (AD) provisions; countervailing duty and safeguard proceedings; quantitative restrictions; prohibited imports; public procurement and; trade embargoes. Each of these trade regulations involve distinguishing domestic from foreign goods, or distinguishing among foreign goods. Consequently, ROO can have powerful economic implications, not necessarily in themselves, but when they are used to reinforce other trade policy instruments. The ROO experienced great importance since the beginning of the 1980s for several reasons[2]. The globalization of production, together with the increased competition among countries for attracting internationally mobile investment, led to the emergence of new concerns about ROO. The increased use of AD tool and the trials to circumvent the AD measures, either by exporting the products subject to AD provisions from other countries that are not affected by these measures (the third-country circumvention) or by importing the individual parts in a country and assembling them into a final product there, led to more reliance on ROO by the importing countries as an anti-circumvention method[3]. As a result of such developments, the complexity of the ROO increased – a fact that made them be claimed to act as a barrier to trade *per se*. Moreover, the discretionary powers in the hands of national authorities implementing the rules opened the possibility that these rules could be used as instruments of protectionist commercial policies. Finally, ROO were seen as means of "forcing" investors to move production. By maintaining tough or complex ROO, it was argued, countries or regional entities could more or less oblige

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[2]For an extensive summary of the rationales behind the increased importance of rules of origin see: Hoekman, B. (1993), esp. pp. 82-83.

[3]Four case studies on how ROO were used by the EU to prevent circumvention of AD duties are presented in Waer, P. (1992), see esp. pp. 159-179.

foreign suppliers to move production in order to ensure access to the target market(s) (Woolcock, 1996: pp. 195-196).

The role of ROO in regional trade agreements (RTAs) was mainly thought to confine the preferential treatment within the context of a specific RTA to the goods traded among the members[4]. Moreover, preferential ROO[5], have an important function in avoiding trade deflection. The maintenance by each member in a FTA agreement of its own trade barriers against non-members can lead to the problem of trade deflection. This refers to the entry of imports originating in non-members into the low-tariff member of the FTA to avoid the higher tariffs of other members. Combating trade deflection requires checking the original source and the final country of destination of all imports. This problem should not arise in the case of a customs union (CU) because of its common external tariff which prevents any kind of trade deflection[6].

Despite the need for preferential ROO in a FTA to prevent trade deflection, its structuring can lead to trade diversion (WTO: 1995, pp. 48-49). By defining restrictive preferential ROO, exporters in the members of a FTA might have to import certain raw and intermediate products that are more costly than if otherwise imported from non-members to satisfy the origin rules of the agreement. Thus, preferential ROO that define eligibility for duty-free access of goods among members of a FTA provide an opportunity for raising barriers against outsiders while leaving tariff levels against them unchanged and consequently leading to trade diversion[7]. Consequently, even if nominal rates of protection on final and intermediate products are unchanged, the higher the requirement for value added in FTA members (to satisfy the origin rules of the agreement), the more trade in intermediate products is diverted from third countries to members of the FTA (Kreuger, 1993: p. 8; Bhagwati, 1995: pp. 3-4). The scope for this type of trade diversion depends on the size of preferences included in the agreement, the restrictiveness of the ROO, and the extent of disparities in external tariff rates among member countries (Serra, et. al, 1997: p. 13). No matter how ROO are defined in the context of a FTA, they will distort production, because the FTA creates an incentive to have output classified as a member output, and producers will respond accordingly to achieve such aim, thus leading to trade and/or investment diversion. As *B. Hindley* has observed: "From an economic standpoint, taking the economic welfare of the world at large as the criterion, the best rule of origin would be that which allows every trader to choose the origin that suits him best. That would typically be origin in the importing country, and would be tantamount to global free trade"[8]. *A. O. Krueger* goes further in arguing that the existence of preferential ROO by which industries in the member countries of a FTA are protected is likely to give

[4] For an extensive discussion of the role of ROO in the context of RTAs see: Palmeter, D. (1993), esp. p. 326.

[5] This is in contrast with *non-preferential* ROO that a country applies to the goods imported from countries not engaged with it in a RTA.

[6] That is one of the main reasons why some economists see that FTAs should be ruled out and replaced by CUs so as not to affect the world trading system. See: Krueger, A. O. (1995), pp. 25-26. However, practically speaking trade deflection may occur even with a common external tariff in a CU when members countries maintain different national trade rules and policies , such as anti dumping and countervailing duty codes or technical, health, and safety standards. To avoid trade deflection, a harmonization of national trade rules and policies between members of the CU is needed. For a similar argument see: Serra, J. *et al.* (1997), p. 48.

[7] In NAFTA, for example, only apparel products that are 100% North American qualify for duty-free movement across NAFTA member countries. This creates a disincentive for the use of non-NAFTA fibers, yarn and fabric. See Lawrence, R. Z. (1996), pp. 100-101. See also: A. O. Krueger (1995), op.cit., pp. 25-26.

[8] quoted in: Palmeter, D. (1993), op.cit., p. 327.

firms a vested interest in maintaining protection and thus reduce the willingness of the FTA to engage in external liberalization[9]. Thus, ROO can be employed as a major weapon in the arsenal of those who wish to shelter regional markets against the outside world. They may be used to change what might otherwise be a trade-creating FTA into a trade-diverting one, and they may be used to exacerbate the trade-diverting effects of FTAs to which that characterization already applies[10].

The role of preferential ROO as a trade protectionist tool in RTAs has been controversial. On one hand, exporters argue that ROO used in conjunction with other commercial instruments such as AD measures, are being used in a discretionary and discriminatory fashion, as they do not apply to domestic producers. On the other hand, importing countries employing commercial instruments argue that ROO are essential if circumvention of measures such as AD duties is to be prevented and free riders are to be limited[11]. Important to say is that ROO are not the only discretionary tool used to discriminate in foreign trade relations where there are other tools that can be utilized in a rather similar way and do the same job. Among such tools are the mutual recognition agreements, labeling requirements, sanitary and phytosanitary measures, technical specifications, customs procedures and others. However, the unique aspect of the ROO is that they cut across all products compared to the other tools which are probably confined to a set of products.

Preferential ROO, when restrictive, can provide additional incentive for investment diversion[12]. They may motivate, or even force, firms to locate their plants producing intermediate goods within certain members of the RTA to satisfy these rules, albeit the fact that those members may not be the best location from an economic point of view. Restrictive preferential ROO act as local content requirements which force the producer to use a certain domestic content for the product to be considered of home origin and not an import subject to trade penalties. The outcome of restrictive preferential ROO is similar to local content as foreign producer(s) substitute domestic and/or regional inputs for foreign inputs. This will have repercussions for profits, employment and factor returns requirements for the usual variety of economic and non-economic reasons, which is not always the first best solution from an economic point of view. Consequently, the 'hub and spoke' phenomenon which may be a characteristic of a large number of contemporary FTAs can be greatly exacerbated and complicated by ROO. For example the US has FTAs with Canada and Israel with different ROO. If additional FTAs are formed by the US with other countries, and if these FTAs involve separate and different ROO, the result could be the erection of complex discriminatory arrangements that have a major distortionary effect on investment allocations[13].

In some RTAs, ROO can be subject to a "cumulation" procedure. According to this procedure, ROO are broader in their geographical coverage required for a certain product to confer origin. In other words, ROO of a certain product in a given exporting country confer to the required ROO set by the RTA if they are *partly* allocated in that exporting country on condition that the rest of the requirements to fulfill the required ROO be done

[9] cited in: Lawrence, R. Z. (1996), op.cit., pp. 100-101.
[10] For a similar argument see: Palmeter, D. (1993), op.cit., p. 336.
[11] For the argument of the free riders see: Vermulst, E. (1992), p. 480.
[12] One well-published case was the US company Intel, which complained that changes introduced by the European Community in 1989 to the definition of ROO for integrated circuits "forced" the company to invest in Ireland. See: Woolcock, S. (1996), op.cit., pp.195-196.
[13] See: Palmeter, D. (1993), op.cit., p. 337.

in other countries that are agreed upon from the members of the RTA. This procedure relaxes the restrictiveness of the ROO and reduces their negative impact on production distortions and trade and investment diversion. However, some experts argue that cumulation is likely to have negative consequences on the developmental efforts of developing countries engaged with developed partners in RTAs. The argument asserts that the cumulation procedure helps to maintain inefficient industries in some if not all of the countries signatory to the agreements and hinders yet again the developing country producers from sourcing from the cheapest or highest quality suppliers thus maintaining their present levels of under-industrialization[14]. Nevertheless, this argument lacks coherence as if ROO did not allow for cumulation then trade diversion and production distortions will probably increase to be able to satisfy those strict ROO (by the necessity of importing inputs from the members of the RTA whether they are efficient or not) so as to benefit from the duty free treatment granted only for the products conforming the preferential ROO of the agreement.

Finally, it is worth mentioning that the differentiation between preferential and non preferential ROO does not necessarily imply a better or more lax treatment for products enjoying preferential ROO. In other words, it can be the case that that the non preferential ROO are more liberal than preferential ROO which is the case in a number of sensitive sectors that have enjoyed protectionist measures under certain agreements- witness the textiles and ready made garments- and hence devising preferential ROO can act to deprive the members of a certain regional agreement from the benefits they enjoyed by removing such other restrictions. In a nutshell, preferential ROO are a matter of more intensive discrimination against certain countries whether they are members or non members of a regional trade agreement.

3. Different Methods for Determining ROO:

Resolving the issue of origination for primary goods (such as raw minerals, unprocessed vegetable products, live animals and fresh fish) is fairly straightforward. If such goods are "wholly obtained" in the territory of the exporting country, including its territorial waters, or are legally obtained by vessels registered under the country's flag, it is clear that they originate in that country[15]. By extension, goods processed in one country, which are made entirely from primary inputs originating in any of the members of the FTA, can themselves be considered originating goods, and thus be traded between the members of this FTA under the preferential trade regime[16].

While the criteria to resolve the issue of origination may be relatively simple for primary goods and their immediate derivatives, for most industrial or manufactured products this is not the case. Nowadays, and as a result of the globalization of the production processes of many commodities, most industrial goods incorporate inputs produced in a wide variety of countries. In such cases, which constitute a sizable share of traded goods, the issue of ROO needs to be addressed and negotiated directly as a crucial component of the

[14] For such an argument see: Kingston, E. (1992), p. 14.

[15] However, one must bear in mind, that many primary products are *fungible* commodities in the sense that differentiation between locally-produced goods and similar imported goods may be difficult to ascertain. In that case, the agreement establishing the FTA must include clear rules or guidelines to deal with these cases. See: El-Diwany, S. (1996), esp. pp. 1-3.

[16] Annex D.1. of the Kyoto Convention, the Second Standard is concerned with the "wholly obtained" goods. See: Waer, P. (1992), op.cit., p. 103.

agreement establishing a RTA and especially a FTA. The main intention behind ROO is to make sure that products imported from members in the same RTA satisfy the needed ROO by undergoing a "substantial transformation" to make them eligible for the preferential treatment provided within the context of the RTA.

Substantial transformation:
According to the Kyoto Convention a commodity that combines materials or processes from two or more countries will be considered the product of the country in which it had *last* undergone a *substantial transformation*. A transformation is 'substantial' when it yields a commodity which is 'new and different' from the commodity that entered the transforming process. In other words when the transformation process results in a product with a new name, a new character and a new use. There are mainly three different methods for determining ROO and asserting the "substantial transformation" process[17]. The main methods for determining the ROO that are common in FTAs are: *change in tariff heading; value added criteria and; product-specific process*. In some cases more than one method are applied together to determine the origin of a good.

Change in tariff heading (CTH):
CTH mainly implies that the intermediate inputs must undergo a change in tariff classification heading within the territories of the exporting member of a RTA in order to be considered originating in the exporter member country. The basic notion underlying this approach is that, for most goods, a reasonable way to measure the degree to which an imported input is transformed within the FTA is to compare the tariff heading under which it was imported with the tariff heading under which the final product would be exported. If these two tariff headings are sufficiently "distant", in the sense that they apply to substantially different goods, regional origin can be attributed. CTH confers origin if the manufacture process results in a product that falls under a — normally four digit — Harmonized System (HS) number that is different from the number under which the non-originating parts or materials fall[18].

It is argued that the use of a specific tariff schedule to measure change in the commodity status enjoys transparency, predictivity and to an extent, objectivity (Falvey and Reed, 1998: pp. 212-213). This in turn suggests that there is less scope to use ROO as instruments of industrial or commercial policy. The wide use of the CTH approach in the determination of ROO can be explained by the fact that the act of importing a good into a customs territory automatically generates a documented record of origin and of a tariff heading. Consequently, reliable record keeping can be achieved without requiring that exporters adopt special accounting procedures that they would not use if they were to sell exclusively in the domestic market.

However, the CTH system suffers from a number of shortcomings. For example, the contemporary tariff schedules were not designed with origin determinations in mind. The most widely used tariff schedule, the Harmonized Commodity Description and Coding System (the Harmonized System 'HS'), classifies commodities in a relatively complex

[17] The Annex D.1. of the Kyoto Convention, the Third Standard, notes that the substantial transformation criterion can be expressed in three ways: (1) by a rule requiring a change of tariff heading in a specified nomenclature, with lists of exceptions; (2) by a list of manufacturing or processing operations that do or do not confer on the goods the origin of the country in which those were carried out; or (3) by an ad valorem percentage rule, where either the percentage value of the materials used or the percentage of the value added reaches a specific level. In the Text and Commentary Section, the Annex notes the advantages and disadvantages of the three techniques but does not express a clear preference. Cited in: *Ibid.*, p. 104.
[18] For a detailed description of the CTH see: Vermulst, E. (1992), op.cit., pp. 448-449.

way[19]. With a tariff schedule not designed to facilitate origin determinations, perhaps no single rule or principle is possible. The major shortcoming of the CTH is the absence of any general principle underlying the selection of which specific tariff change is chosen to confer origin on particular articles. In some cases, despite the fact that the product concerned has undergone substantial transformation, its classification under the CTH remains unchanged[20]. In other cases it can be that a trivial change in implies a CTH. Consequently, the inherent vagueness of CTH provides an opportunity for industries to formulate rules specifically tailored to advance their private interests[21]. Moreover, CTH presumes that origin can be determined by a quick refer to the tariff schedules, which is not always the norm as asserted by the regular disputes on customs classification creating a substantial subjective discretion in the conclusions reached. Further, CTH suffers from a tendency to become outdated if the underlying tariff schedule is not kept up to date. When dealing with a particular product area, tariff schedules usually list the major products within the area, and then provide a 'basket' for all their related-products [22]. In rapidly developing product areas, there is a tendency for the trade to move into the basket category as new products are developed and replace those listed in the schedule. This problem can be remedied by keeping the tariff schedule up to date, but if the tariff schedule involved requires international negotiation, this may not always be easy. What industries in one country may see as 'updating', industries in another country may see as threat. It seems unlikely that any significant change would be made in any tariff schedule without the concurrence of the industries concerned, effectively giving a chance for the affected industries to raise their protectionist voices. Finally, CTH can be burdensome and expensive. Producers who, for example, wished to take advantage of the FTAs between the EC and the individual European Free Trade Association (EFTA) countries, which are based on CTH, must have maintained records establishing the tariff classification not only of the finished product but also of all raw and intermediate materials imported from third countries. The cost of border formalities alone needed to administer this system has been estimated to amount to at least 3% of the value of the goods concerned, while the total economic cost has been estimated to amount to at least 5% of that value. This burden was enough to lead exporters of up to 25% of presumably eligible trade to forego the preferences and simply pay the normal Most-Favored-Nation (MFN) tariff rate (cited in Palmeter, 1993: p. 332). The foregoing of the preferential treatment was repeated in the case of Canada-US FTA (CUSFTA) by some exporters due

[19] The Harmonized System of Tariff Classification, classifies commodities at a two-digit chapter level, a four digit heading level, a six digit subheading level and an eight digit statistical level. As a result, the change of tariff heading needed to impart origin will vary between a change at the two-digit level, the four-digit or even the six- or eight-digit levels. A uniform system requiring change at the four-digit level, for example, is not sufficient because of the differences in working needed to change a tariff heading. In practice, therefore, rules of origin based on changes in tariff headings cannot be based on simple formulae. For further details see: Palmeter, D. (1993), op.cit., p. 329; see also: Woolcock, S. (1996), op.cit., pp. 199-201.

[20] The Harmonized System, the tariff classification currently used by most countries, has 1,241 4-digit categories, as opposed to over 5,000 at the 6-digit level. The implication is that for many products a 4-digit CTH criterion will imply that origin will not be granted. Some examples: sweetened cocoa powder is classified as 1806.10 all products containing sweetened cocoa powder are classified as 1806.2-1806.9, i.e. no CTH occurs. Similarly, the creation of coffee substitutes or decaffeinating coffee does not imply any CTH at the 4-digit level, nor does combining fruit juices or transforming imported sodium nitrate into fertilizer.

[21] For example, one CTH rule of origin that is comprehensible to the non-specialist is the rule in the Canada-US FTA (CUSFTA) which provides that the production of the aged cheese from fresh milk does not confer origin on the country where the cheese was made if it is different from the country where milk was produced. See: Palmeter, D. (1993), op.cit., p. 330.

[22] This simply means that any product that is not included by name in the tariff schedule is subject to the rate of duty applicable to an 'all other' or basket category.

to the expensive way of proving origin for their products which apparently followed CTH as well (Woolcock, 1996: p.200).

Value added criteria:
The value added criterion is sometimes called percentage criteria. According to this method of ROO determination, a certain amount of value added, usually between 40% and 60%, to the imported intermediate and primary product(s) (from non-members) is needed to confer origin of the final product in the exporting member of the RTA. The criterion itself can be expressed in at least three forms: *import content test* where a maximum allowable percentage of imported parts and materials is needed; *domestic content test* where a minimum percentage of local value added in the last country where the product was processed is needed and; *value of parts test* where originating parts must reach a certain percentage of the total value of parts to confer origin (Vermulst, 1992: pp. 437-448; Falvey and Reed, 1998: pp. 213). Once this certain amount is measured, it can be compared with a specific percentage parameter (i.e., the bench-mark regional content established by the ROO). If the measured local content of the product meets this parameter, it is considered to be originating in the RTA and therefore eligible for the preferential treatment agreed upon by the members. The value added criterion maybe employed as the sole method of determining ROO or may be used in conjunction with other methods. Because processing and assembly operations often do not result in meaningful tariff changes when parts and components are assembled into a final product, value added method generally supplements the CTH procedure. Like CTH, value added has the advantage of being a rule that may be stated in a transparent and objective way. But also, like CTH, value added may be more certain in its statement than its application.

Calculation of value-added frequently depends upon complex accounting issues which can raise considerable uncertainty. Uncertainty resulting from the use of value added method happens because origin is never finally determined until audits are completed, a process that can take years. If the auditors disagree with the calculations of the parties involved, enormous and unexpected demands for payment of duties may result [23]. Moreover, the dependence on such accounting issues leads to another disadvantage of the value added method, namely the need for lengthy and costly audits to verify value added claims as it is also necessary to carry out audits after the event to certify the costs of work carried out. This makes the value added system expensive to apply, and as with other methods, companies concerned may prefer to pay the non-preferential tariff rather than go to the expense of proving origin. This was the case with some companies in the application of the 1973 EC-EFTA FTA agreements, which made extensive use of value added criterion (Woolcock, 1996: p. 200).

Further, under the value added method, origin may change in unpredictable or unusual ways. The same operations in the same facility may confer origin and may not, depending on the fluctuations in exchange rates and/or material costs. Operations that will confer origin in one country may not do so in another because of different labor cots. For example, if ROO are determined according to the value added criteria in the Egyptian-European FTA, origin and preference eligibility will be conferred more easily under the value added criterion on higher wage EU members' operations than on lower wage Egyptian operations. Therefore, from a strict economic point of view, value added criterion that only looks at figures relative to the total production cost of the product and not relative to the economies of the producing countries involved might not produce

[23] For more details see: D. Palmeter (1992).

adequate results in a world trade order that is currently characterized by countries with widely different production costs and levels of economic development. Thus, in general, value added measurements may imply a systematic bias against the lower-wage members of a RTA(Vermulst, 1992: pp. 446-448). Other factors may substantially reinforce this bias: for example, if customs duties paid on imported inputs are not allowed to be accounted as part of the regional component and/or if duty drawback on exports is prohibited an additional bias against the low-wage, less developed member is introduced. This is simply because the domestic availability of the required inputs is likely to be more limited in that member when compared with those available for the more developed member of the RTA. In this way, the value added criterion for determining ROO may distort economic efficiencies and divert investment from where it might have otherwise occurred.

Product specific process:

The product specific process is sometimes referred to as the *technical test* (Vermulst, 1992: p.45). Under this methodology, ROO are drawn in terms of concrete industrial operations. In other words, to determine origin is to specify that "substantial transformation" has occurred when a specific production process has been carried out. This test explicitly specifies production or sourcing processes that may (positive test) or may not (negative test) confer originating status (Falvey and Reed, 1998: pp. 213-214). This test amounts to specifying a technical definition of substantial transformation and therefore is sometimes referred to as "technical test". The system has the advantages of transparency, predictability, and less subjectivity. Moreover, it is the least costly method of determining origin (Woolcock, 1996: p. 200).

However, it suffers from a number of disadvantages as well, the most important of which is obsolescence, as technical developments may tend to overtake the texts of specific rules. The product specific process can also be subject to discretionary protectionist pressures from some concerned industries. When governments base rules on the details of industrial processes, the industries concerned are likely to have a major influence in their formulation. Since 1984, for example, the US has used a specified process system for its textiles' ROO. These rules are widely perceived as having been driven by the protectionist interests of domestic textiles industry (Palmeter, 1987: p. 26). Finally, to have a comprehensive product specific process encompassing all the products traded internationally is likely to be impossible, due to the huge variety of products traded and the various as well as changing production techniques used in their production. Thus, product specific process has some serious limitations which deprive its use as a major method applied in practice. Nevertheless, it is applied either alone when determination of ROO cannot be done depending on CTH[24] or, more often, as a supplementary method used in conjunction with other methods for determining ROO and in particular with CTH.

Summary:

[24] For instance, ROO for semiconductors may require that the product is subject to a process known as diffusion within the FTA for it to be considered originating in that area. Or, in the case of printed fabric, the rule may require that the printing itself of the raw cloth, which may imply performing one or more standard processes, be done within the FTA if it is to qualify as originating. See: El-Diwany, S. (1996), op.cit, pp. 1-3.

To sum up, every method of determining ROO has its shortcomings and is subject to discretionary powers in structure as well as in implementation resulting in the fact that ROO *per se* can act as a trade barrier. Unfortunately, economic theory does not provide a "standard" against which any particular ROO can be judged (Falvey and Reed, 1998: pp. 213-214). Thus, as *D. Palmeter* has asserted "the selection of any particular rule is in many ways the selection of a 'lesser evil'"[25]. Customs authorities have generally opted for combinations of the different approaches in order to balance the objectives of predictability and flexibility against minimum costs in implementing the rules. CTH, supplemented by value-added criteria, seem to be the most widely favored method applied for determining preferential as well as non-preferential ROO in recent years. Consequently, it can be concluded that the contemporary determination of ROO embraces an obvious bias against developing countries. This is mainly due to the reasons identified above concerning the method of value added criterion and its relative bias against developing countries. Moreover, the relatively increased rate of assembly and/or packaging processes undertaken in developing countries that might not result in a CTH of the product concerned and thus the product might not be deemed to originate in their territories intensifies this bias. This is in contrast to the product specific process that embodies a bias against developed countries. Due to the technological progress prevalent in these countries and its impact on the process technology employed in manufacturing their products, the use of the product specific process can in many cases be outdated. Thus, their products can be negatively affected as they will always be faced with problems of identifying their origin to the competent customs authorities.

4. The European Union's Practice in Applying the Rules of Origin in its Regional Trade Agreements

The first act of the EC authorities in the area of origin was Council Regulation (EEC) No 802/68 on the common definition of the concept of the origin of goods called Basic Origin Regulation [26]. With this framework regulation, the EC authorities set a first step towards the harmonization of the non-preferential origin rules, which thus far has been subject to diverging legislation in the different EC Member States. The EC adopted the Kyoto Convention in 1975 and accepted Annex D.1 concerning ROO in 1977. In general, the Basic Origin Regulation follows the Kyoto Convention rules concerning ROO. Few deviations are present, however, not to an extent that can have serious consequences on the application of ROO, at least, in what concerns the non-preferential ROO[27].

In the preferential ROO of the EU, the basic rules are that products will be considered originating products in beneficiary countries if the products have been "wholly obtained" in that country or if they have undergone "sufficient working or processing and have been transported directly to the Community"[28]. EU preferential ROO are addressed to be fairly complex. Contrary to the non-preferential ROO, they have the advantage of being rather precise. Nevertheless, grasping the applicable rules, including cumulation rules, may mean quite an effort for exporters to the EU (Waer, P.,1992: pp. 158-159). To overcome the complexity of preferential ROO and their related problems, the EU together with the EFTA, Baltic countries and Central and Eastern European Countries

[25] Palmeter, D. (1993), op.cit., p. 340.
[26]European Commission (1968), *Official Journal of the European Communities,* Series l 148/165 (Regulation 802/68 or Basic Origin Regulation).
[27] For more details on the similarities and dissimilarities between the Basic Origin Regulation and the Kyoto Convention see: Waer, P. (1992), op.cit., pp.102-108.
[28] See: Waer, P. (1992), op.cit., p. 146. See also: Matteis, J. (1992), op.cit., pp. 420-421.

(CEECs) introduced a unified system for determining ROO in 1997, namely the Pan-European Rules of Origin (Taha, H., 1998: p.3). A major distinguished feature of the Pan-European Rules of Origin is the allowance for different kinds of cumulation procedures (Diagonal and Bilateral) of inputs and industrial processes to confer origin[29]. Such feature of cumulation adds liberal and flexible aspects to the determination of ROO. The Pan-European Rules of Origin allow as well for what is called the 'General-Tolerance Rule' (sometimes referred to as *de minimis* principle or provision). This rule permits the use of the inputs of a third non-member country to the concerned RTA in an amount that exceeds the normal criteria specified by the preferential ROO as long as they do not exceed 10% of the value of the product exported (ex-works price[30]) to be granted the preferential treatment within the context of the RTA.

The different RTAs that the EU has concluded did not always allow for the cumulation rule to be adopted. That was the case in the former EC-EFTA FTA agreements where cumulation was allowed only in certain conditions between EFTA countries. This resulted in restrictive ROO than the case would have been if cumulation was allowed (Hoekman and Leidy, 1993: pp. 232-233). However, after the initiation of the European Economic Area (EEA) between the EU and the EFTA countries in 1992, cumulation was allowed. Moreover, cumulation was allowed between the CEECs and both the EFTA and the EU countries (Diagonal Cumulation) as they have concluded FTAs with both sets of countries. The benefits were seen to be in assisting the CEECs in their foreign trade expansion by enabling them to use EU or EFTA products in their preferential trade with the other group of countries. The arrangement would possibly stimulate investment in the CEECs by encouraging companies based in the EC or EFTA to invest in component manufacturing in these relatively low-cost locations (Woolcock, 1996: pp. 202-204). Thus the EU discrimination, regarding its preferential ROO in concern with the issue of cumulation, can have a vital impact on investment diversion. In a comment on the discrimination of the preferential ROO of the EC, *E. Vermulst* argued "If anything, the rules are an expression of the nepotism fashioned to foster foreign investment in certain countries rather than others"[31]. *Table 1.* lists whether cumulation is possible or not under some important RTAs of the EU.

[29] For example the Pan-European Rules of Origin allows for the *Diagonal Cumulation*, which allows the country engaged with the EU in a RTA and with a third country(s) engaged also with the EU and the country concerned in a RTA, to cumulate factors of production, inputs and industrial processes from the EU and/or the third country(s) to confer origin as long as they follow identical systems of rules of origin. It allows as well *Bilateral Cumulation*, which allows the country engaged with the EU in a RTA to cumulate factors of production, inputs and industrial processes from the EU to confer origin.

[30] Ex-works price means the price paid for the product ex-works to the manufacturer in whose undertaking the last working or processing is carried out, provided the price includes the value of all the materials used, minus all internal taxes which are, or may be, repaid when the product obtained is exported. See: Protocol No. 4, Article 1 in the Tunisian-European Partnership Agreement.

[31] See: Vermulst, E. (1992), op.cit., p.474.

Table 1. : Cumulation Possibilities of Rules of Origin under the Preferential Regional Trade Agreements of the European Union, 1991

Trade Regime	Origin Rule Elements
General System of Preferences (GSP)	- Partial and regional cumulation among certain regional groupings (ANDEAN, ASEAN and CACM)
EFTA	-Cumulation among EFTA countries under certain conditions
European Economic Area (EEA)*	- Diagonal cumulation possible
ACP countries	- Diagonal cumulation possible
Mashreq**	- No cumulation
Maghreb***	- Diagonal cumulation possible
Hungary, Poland and Czechoslovakia (Europe Agreements)	- Diagonal cumulation possible

* Adapted from Woolcock, S. (1996), op.cit., p. 202.

**referring to the association agreements signed between the EC and each of Syria, Jordan, Lebanon and Egypt in the 1970s

** * referring to the association agreements signed between the EC and each of Tunisia, Morocco and Algeria in the 1970s

Source: Vermulst, E. (1992), "Rules of Origin as Commercial Policy Instruments? Revisited", in: E. Vermulst, P. Waer and J. Bourgeois (eds), *Rules of Origin in International Trade: A Comparative Study*, Ann Arbor: University of Michigan Press, pp.433-485, pp. 462-463.

Satisfying the certification requirements of the ROO of the EU is often too costly. The benefit conferred by the preferential schemes in certain cases becomes marginal in comparison with the administrative workload and cost to plan the product mix to comply with the preferential ROO. This often leads to instances where firms, although meeting the necessary conditions for origin, decide that it is simpler and cheaper to pay the MFN tariff rates. Moreover, since the average tariff rate on industrial goods in the EU is less than 6%, costs related to the determination of ROO are relatively significant when compared to the duty exporters to the EU have to pay if they forego the preferential treatment for their originating products (Hoekman and Leidy, 1993: pp. 232-233). For example, a study in connection with EC-EFTA agreement suggested that the cost of the border formalities to determine the origin of products has amounted to at least 3% of the value of the goods concerned (Waer, P, 1992: pp. 158-159). A major achievement related to this issue was undertaken by adopting the Pan-European Rules of Origin, which unified the procedure of the certification requirements by using the EUR1. Movement Certificate.

Sensitive sectors are vulnerable to discretionary protectionist ROO due to the heavy influence of the related industries in the EU. For example, in the basic non- preferential ROO determining textiles, which mainly follows a CTH approach complemented by value added criteria, the value added criteria are set in some cases to reach 60% and 75%. Such different rates of value added criteria are not justified by any reasoning from the European Commission (Waer, P.1992: pp 131-134). It reflects the discretionary protectionist interests in formulating the ROO in the EU. This has a negative impact on many developing countries which are engaged with the EU in preferential RTAs and their exports bundle is concentrated in such sensitive products as textiles and apparel. For example, a study found that about 75% of EC-EFTA trade benefited from the preferential trade regime, while the use of tariff preferences under other schemes such as the General System of Preferences (GSP) was low, mainly as a result of the restrictive ROO. Only 21% of the eligible imports from GSP beneficiary countries into the EC actually

benefited from GSP tariff preferences up to 1992. This is in contrast with the Japanese GSP utilization ratio which was 57.4% in 1986 and 48.3% in 1990[32].

In the RTAs that the EU has signed, which have ranged from FTAs to custom unions (CUs) to other preferential RTAs, the method of determining ROO varied slightly from one agreement to another with differences related to product scope, direct shipment requirements, cumulation rules, and some special origin rules (waer, P, 1992: pp. 144-145). In general, they have been based on CTH supplemented by product specific process and, in some cases, value added criterion or a combination of both.

5. The ROO in the Egyptian-European FTA

The Egyptian-European FTA Agreement deals with the issue of ROO in an attached Protocol to the Agreement that reaches more than 100 pages full of details.

In the case of the goods "wholly obtained" which concerns mainly agricultural products and raw materials, the Agreement provides a relatively adequate comprehensive and transparent treatment. In the case of industrial products that require "substantial transformation", ROO are defined on a product by product basis depending on the change in tariff heading (CTH) as the main method *accompanied by or replaced by* product specific process *and/or* a rather high level of value added that is needed to be achieved to confer origin of a certain product (between 40-60% of the value added in average). In other words, a mixture of the three main methods of determining the ROO is applied. Simple operations of stockholding and assembling are excluded to confer origin of goods. In some products, the determination of ROO depends on other criteria. The criteria are based on a percentage of the total weight of the relevant good (e.g., textiles).

The ROO of the European-Mediterranean Partnership Agreements embody a special provision that allows Egypt and the other Mediterranean-non- member countries (MNCs) that have concluded a FTA with the EU as well as among themselves *and* have the same set of preferential ROO with the EU to cumulate their national inputs (Diagonal Cumulation). This provision is supposed to make the determination of ROO less restrictive. The inclusion of the cumulation procedure is considered to be a liberal approach on the side of the EU regarding its trade relations with Egypt, and the MNCs in general. However, this provision is idle in practice as a result of two main reasons, namely the different set of preferential ROO that some other MNCs adopt and the low intra-regional trade between Egypt and the Mashreq countries. Concerning the first reason, the different set of preferential ROO that the Maghreb countries (Morocco and Tunisia) adopt from those adopted by Mashreq countries in general (that have concluded FTA agreements with the EU) and Egypt in specific can be interpreted in halting the cumulation possibility with Maghreb countries, unless their set of preferential ROO are changed. Nevertheless, it still allows cumulation between Egypt and the Mashreq countries (that adopt the same set of preferential ROO[33]) which were denied such a provision in the former General Cooperation Agreements governing their trade relations with the EU (see *Table 1*). As regards the second reason, and despite the fact that the cumulation provision is a normal one in most of the EU RTAs (see *Table 1*) it is likely to remain leisured in practice. This is mainly due to the low intra-regional trade ratio between Egypt and MNCs in general and between Egypt and the Mashreq countries in

[32] Cited in: Vermulst, E. (1992), op.cit., p.46.
[33] See: Taha, H (1998), op.cit., p. 4.

specific (*see Table 2.*). For example the total Egyptian exports to the Mashreq countries represented only 2.4% of the total Egyptian exports while the Egyptian imports from those countries recorded only 3.8% of the total Egyptian imports in 1994. Nevertheless given the dynamic aspect of trade and the possibility of expanding trade resulting from low trade barriers the potential for increased intra regional trade among Egypt and the other Arab countries still hold.

Table 2.: Geographic Destination of Trade of Mediterranean Non-Member Countries (MNCs), 1994

(%of total exports)

Exporter	Importer												
	Algeria	Egypt	Israel	Jordan	Lebanon	Morocco	Syria	Tunisia	EU	USA	ROW	MNCs	World
Algeria	0.00	0.10	0.00	0.00	0.00	1.20	0.00	1.30	71	17.1	9.20	2.60	100.0
Egypt	1.10	0.00	3.30	0.80	0.60	0.20	1.00	0.40	59	10.5	23.00	7.50	100.0
Israel	0.00	0.10	0.00	0.00	0.00	0.00	0.00	0.00	30	31	38.90	0.10	100.0
Jordan	1.60	0.70	0.00	0.00	2.10	0.10	3.20	0.50	9.1	2.6	80.10	8.20	100.0
Lebanon	0.40	2.60	0.00	3.10	0.00	0.80	0.00	0.50	13	3.2	76.20	7.40	100.0
Morocco	2.00	0.10	0.00	0.10	0.10	0.00	0.10	0.80	74	3.5	19.30	3.10	100.0
Syria	0.80	0.50	0.00	2.10	0.00	0.50	0.00	0.70	57.5	2.2	35.60	4.60	100.0
Tunisia	2.90	0.30	0.00	0.30	0.10	0.60	0.30	0.00	79.4	1.2	14.60	4.70	100.0
MNCs	8.80	4.40	3.30	6.40	2.90	3.40	4.60	4.20					

Source: P. Petri (1997), "Trade Strategies for the Southern Mediterranean", OECD Technical papers, No. 127, Paris: OECD, p. 30.

In the following paragraph the impact of the design of ROO in the Agreement on some key industries that has been identified by the Egyptian government as key industries for exporting are discussed in some details. Such industries include the textiles and clothing, steel industry, chemicals, leather products and agroindustrial industries.

Concerning textiles, the determination of ROO in the Agreement did not go further than what the EU offers for the developing countries within the context of the GSP, which was assessed to be restrictive, or at least ineffective. This reflects that the benefit of the Agreement in extending the market access of the Egyptian exports in the EU remains restricted or at least maintains a status quo position. In a detailed analysis of the impact of ROO on the textile and clothing industry in Egypt, the results were mixed. On the one hand, the Agreement was relatively liberal in some cases (100% cotton yarn and threads, 100% cotton fabric) allowing the need of CTH only to confer origin if yarn is spun in Egypt without any specific considerations to the origin of cotton fibre used in its production. On the other hand, it was highly restrictive in other cases including mixed yarn and thread with 50% to 89% cotton content by weight and, mixed fabric with 50% to 89% cotton content by weight where for example, a mixed yarn made of 75% of Egyptian cotton fibre and 25% of Korean polyester is not to be considered of Egyptian origin. The reason is that the product specific process related to this set of products allows the use of certain non-originating fibres (where polyester is not included) in excess of 10% by weight so that the product concerned can meet the origin rules to be granted the preferential duty free treatment (El-Diwany, S., 1996: pp.6-7). As a result trade diversion will persist if the European Union was not the main supplier of the needed non-

originating mixed yarns (e.g., polyester) for the Egyptian products to confer origin. A simple check was undertaken by investigating the percentage of the Egyptian imports from the European Union in the related product group of mixed yarns (HS 5512-5516). The average non-weighted Egyptian imports from the European Union in that group of products represented only 24.52% of the total Egyptian imports based on data available for the year 1994[34]. The trade diversion effect is magnified due to the high MFN tariffs rate that Egypt attains on such group of products (60%). This will have negative welfare effects on the Egyptian economy as a whole. However, the Egyptian exporters will not face a trade-off between foregoing the preferential treatment if they depend on non-originating inputs in that case, as the high MFN tariff rate will increase the production cost and using analogous inputs of European origin will be cheaper. Moreover, despite the percentage of Egyptian imports in that category of products from the EU is *on average* low (24.52%), further dissagregation reveals another story. For example, the Egyptian imports of the product with the tariff line (5514.13) from the EU is 0% of its all imports, whereas the Egyptian imports of the product with tariff line(5514.39) from the EU represent 100% of its total imports. This implies full trade diversion effect in the former product and zero trade diversion effect in the latter product. On average, the restrictive ROO in the textile industry are in line with the anticipation that the abolishment of the textile quota for the Egyptian exports in the EU market, which will follow the same lines as those of the abolishment of the Multi-Fiber-Arrangement (MFA), is likely to result in a restrictive construction of ROO for that specific sensitive industry. The reason is that the influence of the EU producers in formulating the EU trade policy is by all means hard to ignore as the EU cases of antidumping against Egyptian textile products in the 1990s demonstrated. The determination of ROO in that sensitive industry in other RTAs can also be taken as an evidence on the powerful influence of interest groups dealing with 'sensitive products' as textiles in influencing their national governments on decisions related to the formulation of ROO.

In the case of leather products we trace the status of the intermediate and raw materials used in such industry and check for the ROO needed in identifying the nationality of the Egyptian leather products entering the EU market. The most important intermediate input used in the leather products industry is the leather whether before or after passing different stages of processing (HS 41,HS 42 and HS 43). Most of the required changes that are needed to confer origin are specified under CTH with the exception of HS 4109 (patent leather and patent laminated leather, metallized leather), ex HS 4302 (tanned or dressed furskins, assembled: plates, crosses and similar forms), and HS 4303 (articles of apparel, clothing accessories and other articles of furskin) where such items need more specific product operations that are relatively more strict. The average applied tariff rate on HS 41 is about 30% which is relatively high indicating a potential trade diversion especially if Egypt does not import from Europe all the needed requirements for its industry. Following the items of HS 41 on an 8 HS digit level disaggregation, we find that most of the Egyptian imports come from Europe with the exception of 2 items (HS 41041090 and 4109 where Egyptian imports are divided between EU and the rest of the world. Hence, trade diversion is not expected to be high with the exception of those two items where we find that the EU has imposed more restrictive ROO as it is the case with HS 4109. HS 42 has a higher bound tariff rate and a high applied tariff rate. Moreover, the imports from the EU do not represent a large share of the Egyptian total imports.

[34] Based on author's calculations from unpublished data of tariff schedules by country of origin and value where HS is used at a dissagregation level of 8 digits for the year 1994 by Central Agency of Public Mobilization and Statistics (CAPMAS).

Hence it is expected that with the entry into force of the agreement more trade diversion will occur. The final impact depends on how Egypt will handle its tariff structure after the implementation of the agreement. The third category HS 43 has a higher applied and bounding tariff rates. Egypt does not import a large amount from that category with the relative exception of HS 43022000 where its products are imported from the EU mainly. Hence trade diversion is not expected in that category and the more restrictive ROO have no actual effect. Nevertheless, low Egyptian imports can be a result of the high tariff rate (bound is 70% and applied 40%) which indicates a huge trade diversion effect if the high tariff rate has resulted in prohibitive impact. The leather industry indicates that the ROO are neither too restrictive nor liberal. The design and the method used in approving ROO show that the negative impact of ROO does not arise from the method used whether CTH, product specific process or value added but rather arises from the absence or low intra regional trade and high tariff rates that Egypt applies.

A major loophole that can withdraw the benefits of liberal ROO determination in the Agreement is the Article concerned with the issue of "duty drawback". The Agreement establishes a broad prohibition on the granting of drawback, or any exemption for custom duties on imported inputs, when those inputs are used to manufacture products for export (to be applied after six years from the entry into force of the Agreement). However, all manufactured products can be granted a concession of duty drawback refund in the range of 5-10% if Egyptian authorities apply for. As this Article reveals, the fact that this duty drawback is not automatically granted to the Egyptian exporter, rather has to be applied for by the related Egyptian authorities (probably Customs Authority), throws doubts on the effectiveness of such provision. Furthermore, the burden of proving that no exemption from the duty drawback refund was granted is placed on the exporter, who must present to the competent authorities all necessary documents attesting to the fact. The effect of this provision will vary from an exporter to another depending on his usage of imported inputs. However, it can be argued that an elimination of existing duty drawback is likely to offset the benefits of tariff reductions obtained as a result of the Agreement. Moreover, there is an obvious discrimination in the European treatment to other MNCs. While this prohibition was mentioned in the FTA Agreement between the EU and Israel [35] as well as in the so-called 'Europe Agreements' with the CEECs[36], it has not been the case with other countries. In the case of the MNCs, and especially in the cases of Tunisia and Morocco, no special Article was devoted to this issue in their Partnership Agreements with the EU[37].

A positive aspect of the Agreement is the application of the "roll-up" system similar to the one included in the EEA as well as in the European Partnership Agreements with Morocco, Tunisia, Jordan and Israel. This system relaxes the restrictivness of the ROO embodied in the Agreement[38]. Another positive aspect of the Agreement is the

[35] See Protocol 4, Article IV in the Israel-European Free Trade Area Agreement signed in 1995. Cited as well in: Friedrich-Naumann Stiftung (1996), "Total Cumulating of Rules of Origin in Exporting to the EU from Israel, Jordan, Egypt and the PNA", paper prepared and published within the project for Israeli-Palestinian-Jordanian Industrial Cooperation, June 1996.

[36] In the cases of Central and Eastern European countries, they were allowed for being granted the duty drawback in the range of 5-10%, depending on the kind of product for a transitional period of two years that can be extended. See: Taha, H. (1998), op.cit., p. 4.

[37] See the Tunisian and Moroccan-European Partnership Agreements, the Articles related to the rules of origin. European Commission (1995b), op.cit.

[38] Under this system, once a product acquires EEA origin, the percentage of non-originating products or value used in the manufacture of the product is no longer considered. For example, if the casting of an engine block is machined or worked in the EEA, its tariff heading changes and it acquires EEA origin. The

application of what is called "General Tolerance Rule" or the *de minimis* provision. According to this rule, inputs or factors of production from a third party, not included in the preferential treatment related to the ROO embodied in the Agreement, can be acquired in the production of the product granted the preferential treatment. However, the value added attributed to those inputs should not exceed 10% of the ex-works price of the final product for which the originating status is claimed[39]. The inclusion of this provision helps in relaxing the restrictivness of the ROO. Comparing the Egyptian-European Partnership Agreement with analogous RTAs that include both developed as well as developing countries such as NAFTA, we find that the provisions of ROO in relation to those two aspects (roll-up and General Tolerance Rule) show a more liberal approach provided in the case of the Agreement. Where in the case of NAFTA no roll-up system was provided, we find that this is included in the case of the Agreement so as well the General Tolerance Rules which is more liberal in the case of the Agreement (10%) compared to NAFTA (7%).

A potential problem related to the Protocol concerned with ROO within the context of the Agreement is the absence of any special language concerning ROO for services. Despite the fact that services are not liberalized within the context of the Agreement, the increasing role that trade in services is taking is likely to create problems in this matter, especially that there is a provision in the Agreement that calls for liberalization of services in the future. The role of the Customs Cooperation Committee, as a dispute settlement mechanism, in this regard is open to doubt as nothing in the related Articles deals with this issue. The issue becomes more magnified as the definition of the term *goods* in Article 1 of the ROO Protocol means both materials and products. The term products is further defined as products being manufactured. Such definitions do not give a clear cut answer regarding some services which are hardly defined or ambiguously correlated with goods (e.g., computer software).

6. Review of Determining the Rules of Origin in other RTAs Worldwide

Given the fact that there are no precise rules governing the determination of preferential ROO in RTAs set by the international trading institutions (World Trade Organization and World Customs Organization), a review of the methods applied in determining preferential ROO worldwide provides a comparative dimension for those that are adopted within the context of the Egyptian-European Partnership Agreement.

The EC-EFTA FTA agreements concluded in 1973 depended heavily on CTH supplemented by value added criteria for determining ROO. They were assessed to be restrictive[40] and created some tension, especially from the US side. In contrast, the European Economic Area (EEA) Agreement initiated in 1992 created less tension. The

engine block can then be used in an engine assembly as EEA-originating product. In other words, the value of the initial non-originating unmachined casting is no longer considered in the calculation of the total value of the assembly. This system is said to make the ROO more liberal.

[39] Nevertheless, this tolerance cannot be added to the percentage rules relating to value added specified in the annexes. See: Taha, H. (1998), op.cit., p. 4. For the application of this provision in the case of the Israeli-European Free Trade Are see: Friedrich-Naumann Stiftung (1996), op.cit., p. 5.

[40] One study of trade between the EC and individual EFTA countries found that the costs associated with the ROO imposed by the EC were high enough (3-5% of FOB price) to cause EFTA producers and exporters to pay the relevant MFN tariff on one-quarter of EFTA's exports to the EC, rather than satisfy the input requirements and/or do the paperwork necessary for duty-free entry. Cited in: the World Trade Organization (1995), op.cit., p. 49. See also: Krueger, A. O. (1995), op.cit., p. 26.

EEA provides an example of what may be seen as the EU approach to its preferential ROO. The EEA uses a combination of CTH and value added criteria and sometimes CTH and specific product process, though limited. The four-digit HS is used for CTH application. When value added criterion is applied, it usually ranges from 50% (chemical products) to 60% (wide range of investment goods and industrial products). For example, automobiles and general machinery require 60%, as do electronic goods and electronic components. Textiles and clothing use both CTH (for clothing, for example) and product specific process (as in the case of woven cotton fabrics, which must be made from single yarn) (Woolcok, S., 1996: pp 202-203).

The EEA uses the EU "roll-up" system. The EEA also provides for the 'General-Tolerance Rule' under which up to 10% of non-originating products can be used without being considered as affecting origin, provided the use of these non-originating products does not mean that the value-added ceilings are exceeded. This gives the system some flexibility and helps minimize the number of cases in which production or processing decisions are based on the need to gain origin status. The EEA agreement on ROO contains a list of processes which do not contribute to origin (insufficient work). Such processes are mainly concerned with packaging and simple assembly. Items that undergo outward processing (i.e., that are exported or processed or further worked outside the EEA and then reimported) are treated as originating within the territory of the EEA, provided the value added outside the EC or EFTA is less than 10% of total value added and work outside the EEA does not result in the cumulative total of value added exceeding any set value added limits. These outward processing provisions do not apply to textiles and clothing, providing another example of how sectors facing intense import competition will find some means of capturing the process of determining ROO, no matter what method is used (Woolcock, S.,1996: pp 202-203).

In the Canada-US FTA (CUSFTA), ROO were determined mainly by the application of the CTH and/or a value added criteria of at least 50%. For some products, automobiles and textiles in particular, the value added needed was higher. No ascertainable rule or principle was employed in determining what level of change would be required for any particular product. As asserted by some experts, the application of such rules was subject to discretion (Hoekman and Leidy, 1993: p. 234; Palmeter, D, 1993: p. 334). The CUSFTA contained, as well, ROO concerning services. The main criterion involved in determining the origin of services was the nationality of the service provider either in terms of ownership or control.

In NAFTA, the FTA between US, Canada and Mexico, the CTH supplemented by value added criteria are the main rules applied in determining ROO (Palmeter, D., 1993: pp. 330-331). Compared to the EEA Agreement, the NAFTA places a greater reliance on CTH and less use of value added criteria, which is applied more intensively in the case of sensitive sectors as textiles and automobiles. Regarding automobiles, there is an initial regional value-added requirement of about 55%. In the textiles sector, the value added required is so high resulting in a very restrictive ROO in this area[41]. Unlike the EEA,

[41] For example, under NAFTA ROO, clothing produced in Mexico gains tariff-free access to the US market, provided it meets the "yarn forward" rule, which for many products requires virtually 100% sourcing of inputs in North America. Mexican clothing manufacturers face a choice between sourcing all inputs beyond the fiber stage in North America and obtaining FTA treatment, or sourcing inputs outside the FTA at potentially lower cost, but foregoing duty-free access to the US and Canada. If profits are higher under the first option, Mexican clothing manufacturers will opt for "North American" status and stop buying from lower-cost-third-country suppliers. Alternatively, there can be situations in which it is more profitable to select the second option. See: World Trade Organization (1995), op.cit., pp. 48-49.

there is no "roll-up" system in NAFTA. Revisiting the earlier example (see above), this means that a non-originating casting machined inside the NAFTA territory will acquire NAFTA origin, because of a change of tariff heading, but when that casting is used in an engine assembly, the value of the non-originating casting will be deducted when it comes to calculating the value-added for the engine as a whole. The main reason for excluding the "roll-up" system from NAFTA was the fear of the US from the low cost Mexican automobile assembly industry which could result in the import of components from a non-NAFTA country for further processing in Mexico to produce a final product of "Mexican" origin. There is 'General-Tolerance Rule' provision which allows for a certain level of non-originating material, however less than that provided within the context of the Pan-European Rules of Origin (7% under the former compared to 10% under the latter). As EEA, there is a list that excludes simple processes which do not confer origin, however this list is shorter than the EEA list. The NAFTA provides for an "advance origin ruling" for exporters. This rule enables them to know what the origin determination will be in advance of exporting. The NAFTA also includes an origin test for services. The key criterion in determining origin of services is a test of the location (and not nationality) of ownership and control of the company providing a service (Hoekamn, B., 1993: p. 90).

In ASEAN FTA, a product is deemed to be originating in ASEAN members if at least 40% of its value added originates in any member state)Palmeter, D., 1993: p. 234).

The Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) relies on a 50% value added standard. It also requires that the last process performed in the manufacture of the goods involved be performed in the territory of the exporting member state (Steele, K. and S. Moulis, 1992).

MERCOSUR basically provides for CTH based upon the nomenclature of the Latin American Integration Association, supplemented by a 50% value-added test for processing operations (Palmeter, D., 1993: p. 234).

Thus, as seen from the above review, CTH supplemented by value-added criteria, seems to be the most widely favored method applied for determining preferential, as well as non-preferential ROO, in recent years. The use of this system in FTAs seems particularly susceptible to capture by industries whose interests lie in trade-diverting rather than in trade-enhancing RTAs [42]. Such disadvantage of the CTH will continue as long a general principle underlying the selection of which specific tariff change is chosen to confer origin on particular articles is absent. *Table 3.* Summarizes the main methods used in the determination of preferential ROO.

[42] For example a study carried out to check for the effects of rules of origin applied to Mexican exports to the US under the NAFTA found that 86% of Mexican exports to the US fulfilled the rules of origin. However, when the pattern of trade at the sectoral level was investigated, it was found that a significant correlation between the use of NAFTA preferences and the restrictiveness of rules of origin prevailed. Cited in: J. Serra, *et al.* (1997), op.cit., p. 14.

Table 3.: Methods of Rules of Origin Determination in the United States, European Union, Australia, Canada and Japan, 1991

Type	US	EC	Australia	Canada	Japan
Non-preferential	Product specific process	Product specific process or value added	Value added	Value added	CTH or Product specific process
Preferential	value added; CTH or value added for Canada-US FTA	CTH; value added and/or Product specific process	Value added	Value added; CTH or value added for Canada-US FTA	CTH; value added and/or Product specific process

Source: E. Vermulst (1992), "Rules of Origin as Commercial Policy Instruments? Revisited", in: E. Vermulst, P. Waer and J. Bourgeois (eds), *Rules of Origin in International Trade: A Comparative Study*, Ann Arbor: University of Michigan Press, pp.433-485, p. 436.

7. Conclusion and Policy Implications

The analysis in this study aimed at providing a highly consolidated assessment of the impact of ROO within the context of the Egyptian-European Partnership Agreement on the Egyptian economy. It remained short of providing a detailed assessment of all sectors due to data, space and time limitations[43]. However, the main conclusion reached from the assessment undertaken is that the agreement rules of origin are highly similar to other RTAs' ROO and might be including more liberal aspects than other contemporary regional ROO (the roll up system and the General Tolerance Rule). Moreover the analysis showed that the design of the rules of origin is not the only main factor that determines whether trade diversion will occur or not but rather the level of tariffs and the original main source of imports play a major role in this regard.

Other main conclusion indicates that the determination of ROO according to the Egyptian-European Partnership Agreement suffers from the potentiality of abuse by protectionist industries in the EU. The reason is that the product specific process applied in companion of CTH and the determination of ROO on a product by product basis allow the protectionist pressures to tailor ROO in line with their own aims. This is in contrast to the application of one rule (using a certain fixed value added criterion for example) for all products where discretionary powers will be limited and the potential losses in one industry can be traded off against the anticipated gains in another industry[44]. However, the problem is that in the case of utilizing the value added method and/or in the case that the value of the materials utilized in transforming the product exceeds a specified percentage of the value of the transformed product, no international rules were set neither by the Kyoto Convention nor by the GATT/WTO system. Thus, the room for applying discretionary protectionist ROO will remain open[45].

[43] However, that is a natural feature of studies dealing with ROO. According to B. Hoekman (1993), op.cit., p. 92: "The paucity of empirical studies may reflect methodological difficulties as well as inadequate recognition of the potential importance of rules of origin as trade barriers. If tariffs are used, the impact of rules of origin is relatively straightforward to measure: it could be calculated as the proportion of imports that in principle, satisfy the rule but which pay the duty. The problem is to determine which exports satisfy the rule, something that will generally be difficult for a researcher to determine. If quotas are used rather than tariffs it is even more difficult to measure the effect of origin rules.".

[44] For a similar argument, despite not specific to the Egyptian-European Partnership Agreement see: Lawrence, R. Z. (1996), op.cit., p. 104.

[45] For a similar argument see: Serra, J. *et al.* (1997) op.cit., p. 43.

Fear from trade deflection and the expected hub and spoke effect creates an influential pressure on Egypt to lower its trade barriers against non-members. Since the average MFN tariffs rate in Egypt is substantially higher than that of the EU, then trade deflection as well as the hub and spoke effect can apparently happen. Despite the fact that ROO should prevent or minimize such effect, the administrative burdensome work and the associated substantive costs certainly act to reduce the benefits of the Agreement. The predicted impact of ROO on creating a pressure on Egypt to lower its MFN tariffs rate against non-members to avoid trade deflection is in line with the theme of argument asserting that the benefits to Egypt from the Agreement may arise mainly from its trials to avoid its negative effects. As asserted by *D. Palmeter*, "The trade-diverting effects of rules of origin in CUs and FTAs can be reduced… by multilateral tariff reduction and quota elimination. The lower the MFN trade barriers, the lower the importance of rules of origin"[46].

Furthermore, since the intra-industry trade is relatively limited between Egypt and other Mashreq countries and since the potential effect of cumulative ROO is not so promising the hub and spoke effect of investment is likely to expand. Investors will prefer to locate in Europe and enjoy the duty free access for their products in Egypt and other Mashreq countries than to locate in Egypt where the ROO will act as a restriction on their products to be exported duty-free to the EU. This exerts extra pressure on Egypt to improve its intra-industry trade prospects with Mashreq countries, speed up its FTA agreements with those countries and concentrate on the niche products that can benefit from the cumulation effect of ROO (see *Table 2*).

The restrictive ROO in some cases, as those related to some sectors of the textile industry (see *Section 5*), will either result in more trade diversion or in foregoing the duty-free treatment by the Egyptian exporters for their exports. The reason is that restrictive ROO (those which require high regional value added requirements, for example) forces the exporters to import their non-local inputs from the EU and not from other countries, even if they are high-cost producers, when they want to enjoy the duty-free access of their products in the EU. The other solution will be to rely on the traditional non-EU suppliers, however, with the foregoing of the duty-free market access to the EU.

Nevertheless, there exist some options by which Egypt can overcome the restrictiveness of rules of origin embedded in the Egyptian-European Partnership Agreement. For example substitution of some materials by others can be undertaken whenever this can help to relax ROO and does not embody technical complications. An example is provided in Section 5 in the case of mixed yarn which contains 75% Egyptian cotton and 25% Korean polyester and cannot be deemed to be of Egyptian origin as polyester is not included in the materials that can be added to confer origin. A simple solution is to substitute polyester by any other material allowed to be added and at the same time guarantee conferring ROO[47]. Transparency and publicity on such manipulation techniques are important strategies to ensure the success of such system. Moreover, if value added criteria is sued it is possible to substitute labor instead of capital to increase the value added provided. Other methods to overcome restrictive ROO include efficient utilization of the General Tolerance Rule and the roll up system. This requires identifying the industries in which the roll up system can be invoked and hence the degree of industrialization needed to expand domestically, even if in a marginal way to embrace

[46] See: Palmeter, D. (1993), op.cit., p. 340.

[47] This is technically feasible as one of the major Egyptian producers of textiles and ready made garments asserted.

such stages needed and hence soften the required CTH. Such a suggestion might require a better-structured industrial policy that takes ROO aspects in consideration. If diagonal ROO are to be encountered then such structuring of industrial policy would be better if undertaken on regional basis.
Another way to manipulate the expiration of the duty draw back system is to utilize the General Tolerance Rule especially in the relatively capital extensive goods which are expected to be more expensive when compared to the cheaper labor intensive goods. In a capital scarce country like Egypt such goods are expected to have a higher proportion of imported intermediates and hence the 10% tolerance rule can help to circumvent the expiration of the benefits of the duty draw back system after 6 years from the entry of the agreement into force.

Other ways of manipulation include the utilization of the cumulation possibility in other RTAs that EU is a member of even though Egypt might not be a member of. For example, the Africa-Caribbean-Pacific-European Union (ACP-EU) partnership agreement signed in Cotonou in June 2000 includes an article (7.11.) that reads the following: "At the request of the ACP States, materials originating in a neighboring developing country, other than ACP State, belonging to coherent geographical entity, shall be considered as materials originating in the ACP States when incorporated into a product obtained there. It shall not be necessary that such materials have undergone sufficient working or processing, provided that…". The rest of the article defines the necessary conditions to confer origin. Hence, Egypt should make use of such opportunities by increasing the trade and industrial cooperation with African countries n this context. Despite the fact that such cumulation possibility excludes products of Chapter 50 to Chapter 63 of the HS code (the textiles and ready made garments which are of special interest to Egypt), other possibilities in different industries are avilable to be exploited.

Finally, it should be asserted that no matter what methodology is used for determining ROO in the Egyptian-European Partnership Agreement, European industries seeking protection will always find their way to influence the structure of ROO applied for achieving their sake. As the experience of ROO determination in different RTAs have shown, sectors interested in defending existing levels of protection have generally been able to structure the ROO in such a fashion so as to maintain existing levels of protection[48]. This seems to happen regardless of the method applied in determining origin of goods and services in different RTAs.

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[48] For evidence and explanation of the political economy considerations of such process in both NAFTA and RTAs concluded by the EU see: Hoekman, B. (1993), op.cit., pp. 93-97.

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