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RULES OF ORIGIN

IN THE ASSOCIATION AGREEMENT AND THE PEM CONVENTION

IDEAL OR NIGHTMARE?



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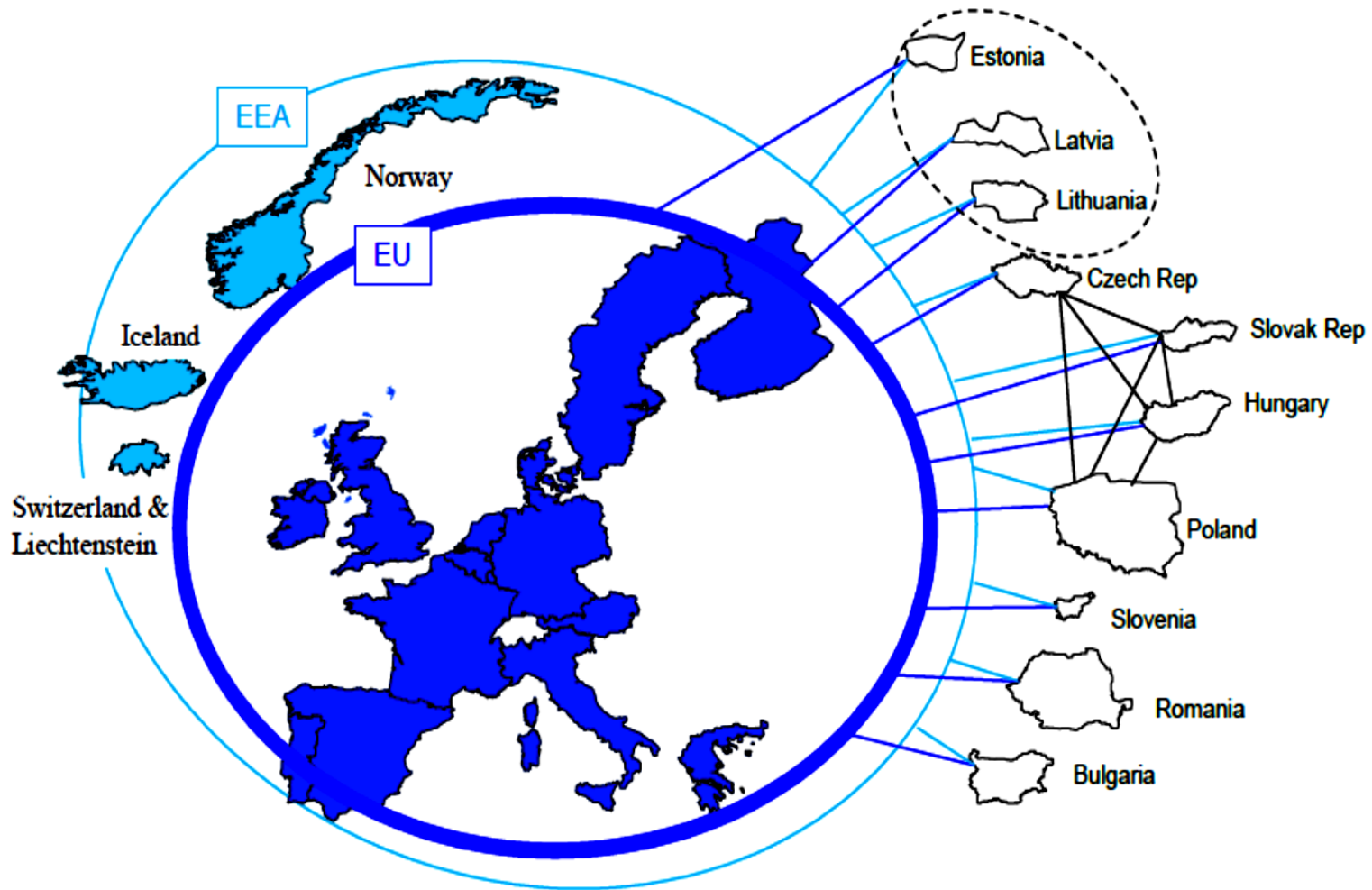
SUMMARY

“Spaghetti bowl”

Restrictiveness of Rules of origin

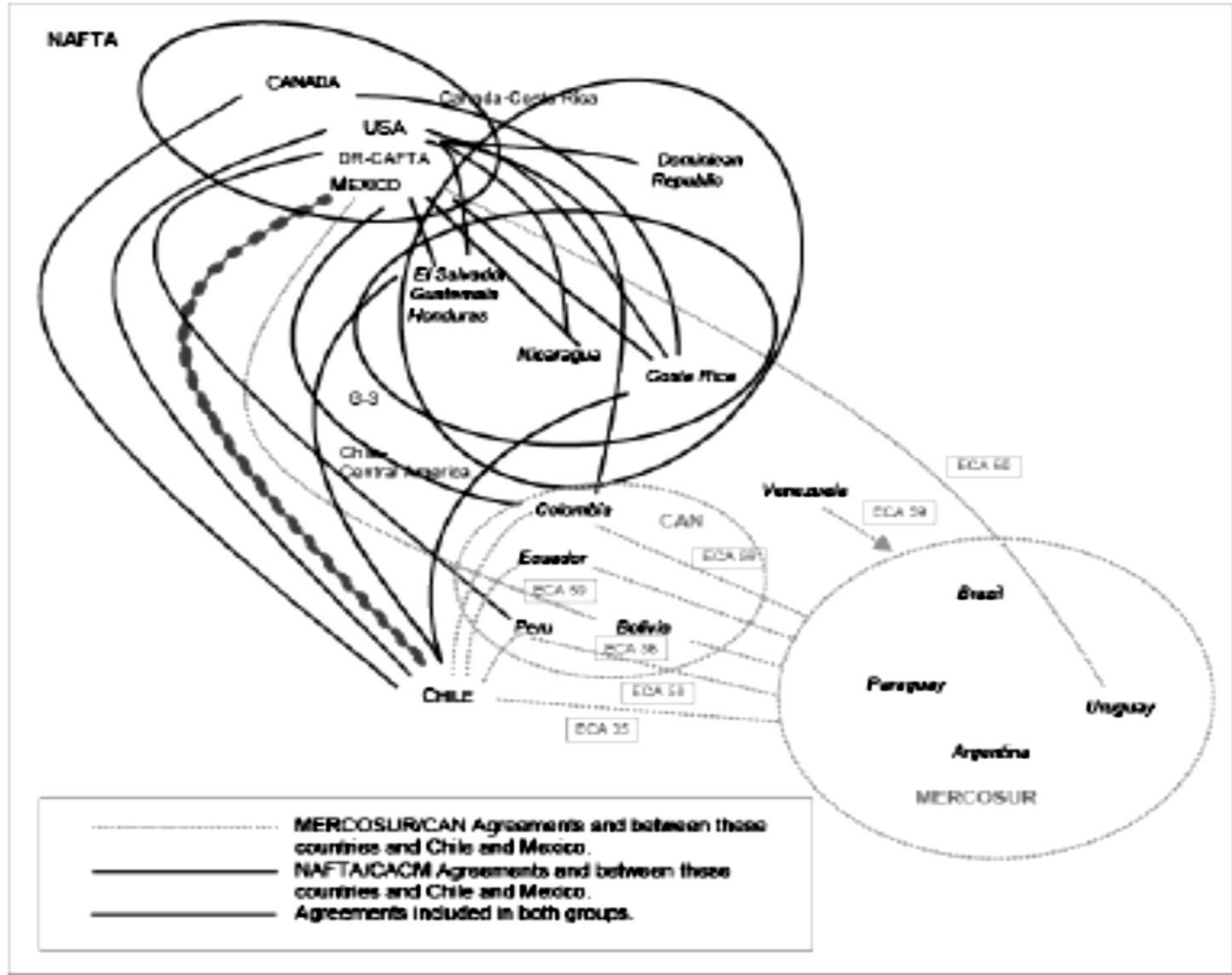
UA Realities and conclusions

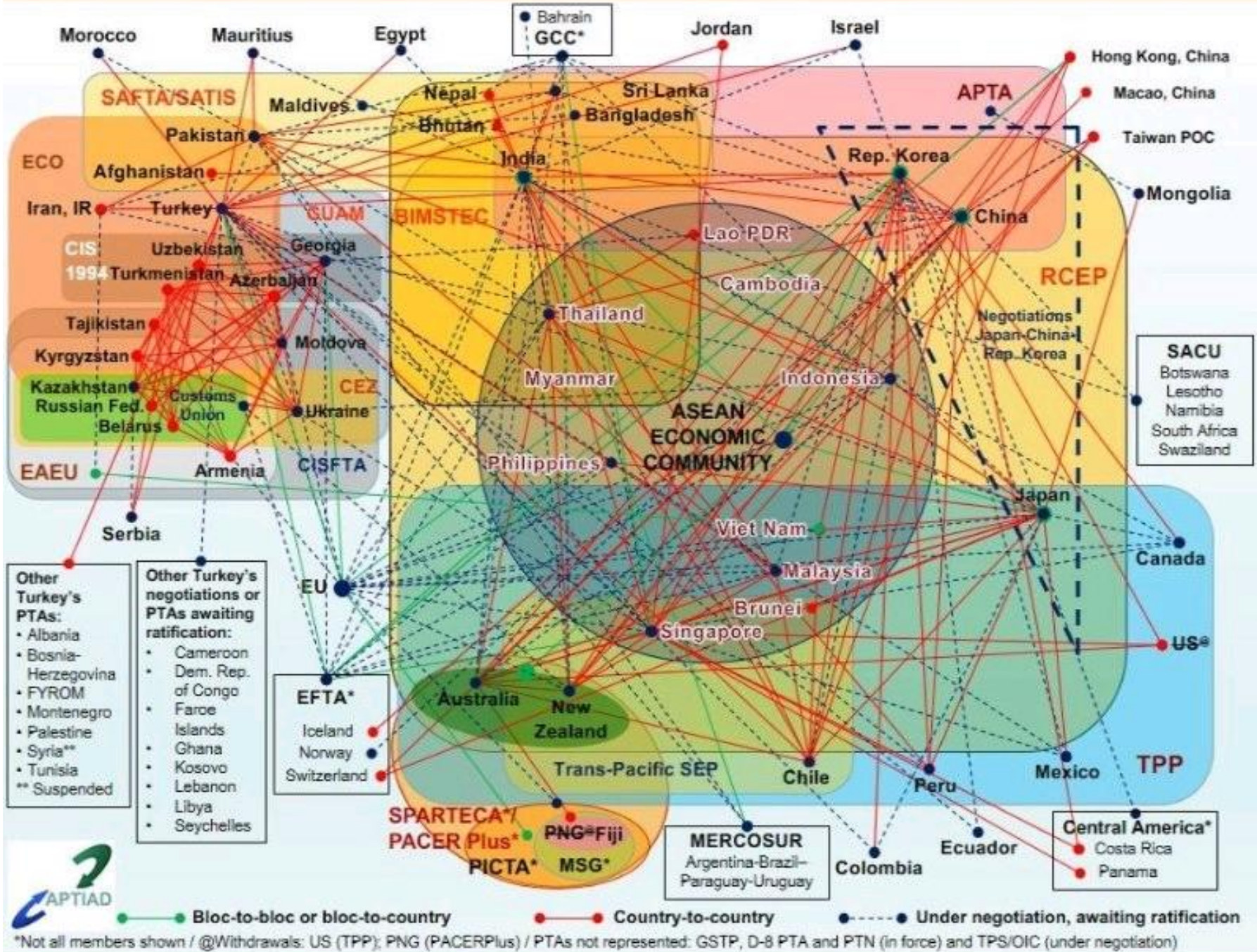
Figure 1: European Spaghetti Bowl, 1995



Source: Baldwin (1994).

FIGURE 1
THE SPAGHETTI BOWL OF ORIGIN REGIMES GENERATED BY 24 FTAs(*)
(Covering 24 Chapters and 38 Annexes of Specific Rules)





How to measure restrictiveness of rules of origin

- Econometric approach
- Practical approach
- Industrial studies (VCAs and Supply chains analysis)
- Tariff levels (usually high tariffs are combined with restrictive rules of origin)



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Econometric approach

Logit model:

$$D_i = f(\text{margin}_i, \text{fta_rate}_i, \text{RoO}_i, \text{sector}_i, \text{stage}_i, \text{cumulation}_i, (\text{margin}_i * \text{RoO}_i), (\text{fta}_i * \text{RoO}_i))$$

OLS model:

$$\begin{aligned} \text{util}_i = & \alpha + \beta_1 \text{margin}_i + \beta_2 \text{fta_rate}_i + \sum_{p=2}^P \gamma_p \text{RoO}_{pi} + \sum_{q=2}^{18} \delta_q \text{sector}_{qi} + \sum_{r=2}^5 \theta_r \text{stage}_{ri} + \beta_3 \text{cumulation}_i \\ & + \sum_{s=2}^S \omega_s \text{country}_{si} + \left(\sum_{p=2}^P \tau_p (\text{margin}_i \times \text{RoO}_{pi}) \right) + \left(\sum_{p=2}^P \varphi_p (\text{fta}_i \times \text{RoO}_{pi}) \right) + u_i \end{aligned}$$

Econometric approach (2)

- Mr. Antoni Estevadeordal, IBRD, goes a bit further than formulas
- Modelling based on assumptions
 - 1) that CC is more restrictive than CTH, CTH than CTSH, etc.
 - 2) correction to the model if there is a value added rule or a processing rule
- Just to complete, Mr. Jeremy Harris, IBRD, later slightly revised this model adding – very correctly – availability of input material considerations into the equation



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Econometric approach

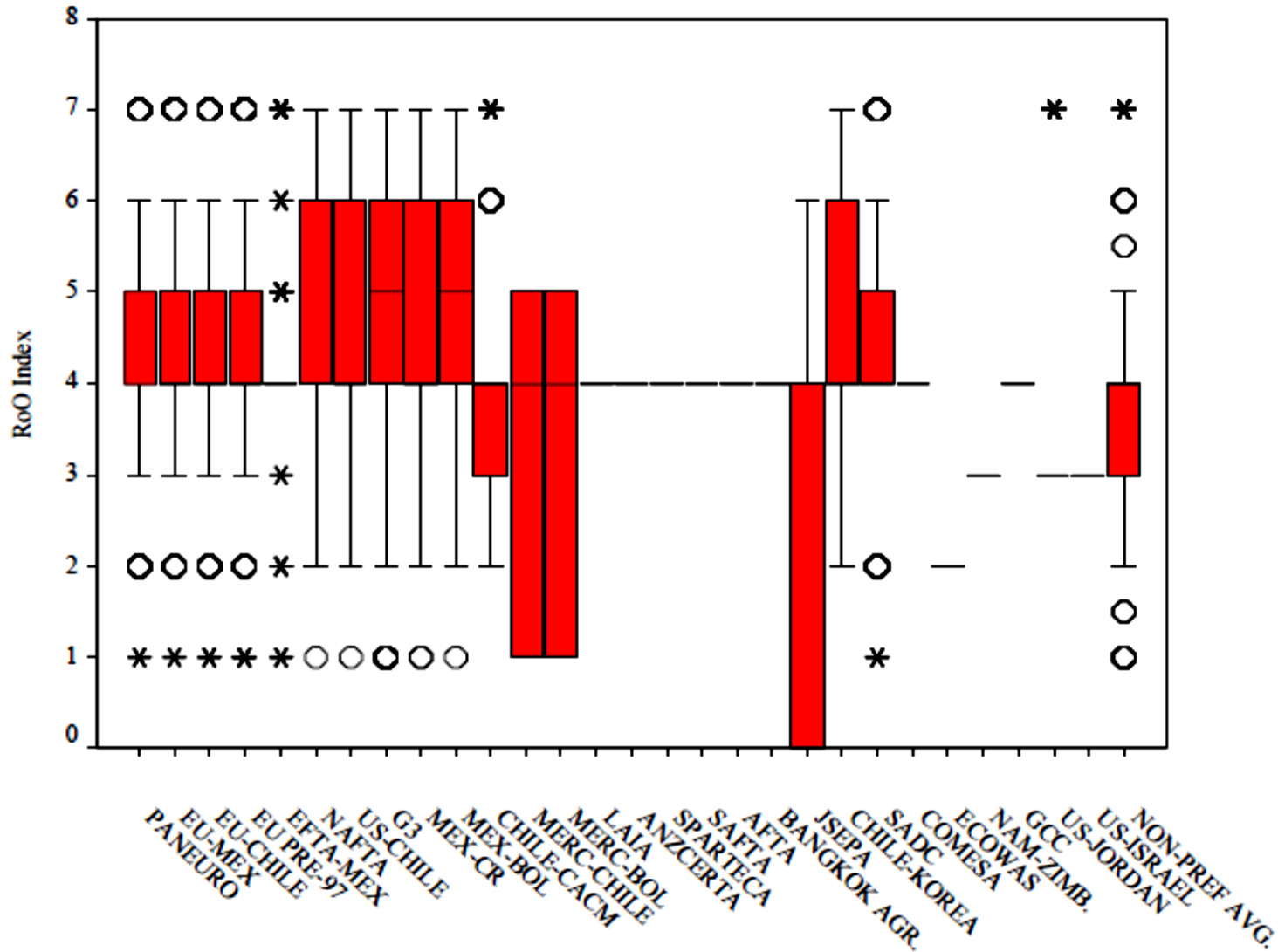


Table 7 – Sectoral Restrictiveness of Sectoral RoO in Selected PTAs

HS Section	PAN- EURO	EFTA- MEX	NAFTA	US- Chile	Chile- CACM	JSEPA	Chile- Korea	SADC	Non-Pref. Avg.
1. Live Animals	7.0	5.3	6.0	6.0	5.9	7.0	6.0	7.0	6.2
2. Vegetable Products	6.6	4.0	6.0	6.0	5.6	7.0	6.1	6.6	6.6
3. Fats and Oils	4.7	4.0	6.0	6.0	3.0	7.0	7.0	7.0	4.0
4. Food, Bev. and Tobacco	5.0	4.4	4.7	5.7	3.7	6.8	5.2	5.4	4.6
5. Mineral Products	3.5	3.5	6.0	3.9	5.3	6.6	5.4	4.0	4.8
6. Chemicals	3.9	3.8	5.3	2.6	2.6	3.7	4.0	4.0	2.5
7. Plastics	4.9	4.9	4.8	3.7	3.2	4.0	4.1	4.7	4.0
8. Leather Goods	3.3	3.5	5.6	5.0	3.7	4.0	4.9	3.8	3.4
9. Wood Products	2.9	2.9	4.0	4.1	3.2	4.0	4.1	4.8	3.3
10. Pulp and Paper	4.4	4.6	4.8	4.9	4.1	4.0	4.3	4.3	3.9
11. Textile and Apparel	6.1	6.1	6.9	5.9	4.5	6.0	5.5	6.1	3.4
12. Footwear	2.8	4.1	4.9	4.8	3.5	4.3	4.7	2.6	3.7
13. Stone and Glass	3.7	3.7	4.9	4.4	4.2	4.0	5.0	3.7	3.5
14. Jewelry	3.7	3.7	5.3	5.2	4.0	4.0	5.4	3.7	3.4
15. Base Metals	4.2	4.2	4.6	4.6	3.8	4.0	4.5	3.9	3.4
16. Machinery and Electrical Equipment	4.8	4.0	3.2	2.9	4.3	6.0	3.8	4.1	3.6
17. Transportation Equipment	4.7	4.2	4.8	4.2	3.4	4.0	4.3	3.8	3.8
18. Optics	5.0	4.4	4.0	4.5	4.0	4.0	4.3	3.9	3.5
19. Arms and Ammunition	4.0	4.0	4.7	5.5	4.0	4.0	4.8	3.1	4.0
20. Works of Art, Misc.	4.1	4.1	5.1	5.3	3.6	4.6	4.7	4.0	3.3
<i>Average</i>	4.5	4.2	5.1	4.8	4.0	4.9	4.9	4.5	3.9

Econometric modelling

- Armington elasticities try to predict trade deflection of Free Trade Agreements
- Econometric models like partial and general equilibrium models try to simulate trade effects
- Practically, what is the reality?



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Ukraine realities

- Loss of major traditional market for heavy industries
- Light industry shows constant trade figures despite the difficulties (i.e. cables and wiring)
- Major exports are wholly obtained agricultural or slightly processed goods
- Backwards in industrialisation

Key sectors in Ukraine:

- Raw materials, iron and iron ore, steel are as well important sectors, but not for rules of origin as the raw material is obtained in Ukraine (under normal circumstances).
- Thus, focus of interest are sectors, which might suffer from restrictive rules of origin:
- Automotive industry (let's consider this an infant industry)
- Accessories and components for automotive industry (i.e. wires and cables/harnesses)
- Machinery sector (i.e. turbo propellers, turbines, telephone sets, electronic components, ...)

Key sectors in Ukraine:

- Textiles and Garments:
undeniable potential due to
geographical location and
production costs in UA
- Shoes: could also be a
promising, even at the
beginning niche market due to
location and cost advantage of

Key sectors in Ukraine:

- Cigars and cigarettes: exports mostly outside the EU, imports too ... thus liberal ROO required. Huge potential but more because other factors.
[Factually, the EU forbid a few years ago to produce cigars and cigarettes which do not comply with EU standards overall, even if such products are intended for export; thus, what happened is that production has shifted outside the EU to serve markets like the Middle East and North Africa which have less stringent rules on tobacco products.]
- Processed agricultural goods (agro-food processing vests great potential seen the powerful agricultural potential of UA
- Wood and furniture: similarly, traditional long-standing promising industry, great potential for exports towards the EU.

Ukraine reality

- Value added in Electrical machinery sector according to UNIDO: 38.98 %
- Other machinery and equipment: 47,5 %
- Motor vehicles, trailers, semi-trailers: 45 %
- Rules of origin for assembly in machinery sector: **60% value content requirement (based on ex-works price of the finished good)**
- Textiles: 2-step manufacturing at the moment, but where to source the fabric?
- Textiles also massively influenced by Least Development Countries policies – EU GSP and US AGOA for instance



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THE BIG QUEST FOR THE MODEL OR IDEAL RULES OF ORIGIN

- Criteria to use?
- Cumulation options
- Tariff levels, transportation costs, supply chains realities
- Level of details
- Additional solutions in list rules

WHAT IS POSSIBLE?

- Restrictive rules → easing solutions
- Liberal rules of origin → with exceptions
- Same FTA, different rules of origin for specific countries?
- Industrial development realities
- Investment incentives – FDI

VALUE ADDED CRITERIA

- Threshold issue – what is the fair limit?
- FOB
- Ex-Works
- Value of non-originating vs. originating materials used
- Lower value for specific products of interest

Tariff Heading Change

- Compensate for the imperfections in the Harmonised System
- Split some headings into final goods and parts
- «CTH» or «CTSH» or «Change to split heading»
- Nevertheless, avoid tariff heading change to confer origin if simple operations
- Tolerance rule

Processing Rules

- Biggest potential to increase options for enterprises
- Non-preferential Rules of origin created some interesting options:
 - «Blank» rule in the machinery sector
 - Chemical reaction and other rules for chemicals
 - Raising of animals as origin conferring (i.e. 4 months of fattening)
 - Already existing: Printing, dyeing, petrochememical processes (the latter hidden in the introductory notes)
- Problem of technological changes, changing rules of origin is a complicated procedure in most agreements

Other options

- NAFTA is known as an agreement with strict rules of origin
- The TPP (Trans Pacific Partnership) would have followed NAFTA approach
- Nevertheless, it gives also flexibility through different «softenings» of the rules
- Tariff Preference Levels (TPL)
- Short supply list (SSL)

NAFTA

Tariff Preference Levels

- To allow flexibility, textile and apparel exports will have access to tariff preference levels (TPLs). This means that specified quantities of yarns, fabrics, and made-up textile goods and apparel goods that do not meet the Article 401 origin criteria (NAFTA), but which are subject to significant processing in one or more NAFTA countries, can still be eligible for preferential NAFTA rates.
- TPLs are measured in Square Metre Equivalents (SME)

NAFTA

- **Short supply list**

- Contains specific request to change the rule of origin for specific products that allows sourcing of fiber, yarn, or fabrics from outside region.
- Requires very detailed inputs from industry
- Allows to soften up the restrictive rule upon availability of raw materials in the region that is covered by the FTA

NO RULES OF ORIGIN?

- FTA without ROO?
- Almost, but it is called Customs Union
- Single external tariff
- All countries should negotiate FTAs together with other regional blocks
- European Union is a Customs Union, thus a single customs territory

General rules that allow flexibility

Extended Cumulation options

Bilateral

Diagonal

Full cumulation

Cross cumulation (more and more used also by the EU, i.e. in the Economic partnership agreements and in the EU GSP)

Tolerance rule

Composition of sets, samples, assembly rules

ADMINISTRATIVE ISSUES

EU Approach was: exporting
country verifies the origin
But, EU GSP approach
introducing REX – Registered
Exporter: importer can verify up
to a certain level himself (and
importing country)

CONCLUSION

- Joining the PEM Convention, UA exporters gain more opportunities
- UA to fully utilise approved exporter schemes
- UA needs to attract FDI, the PEM Convention is one of the many good arguments



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ARGUMENTS PRO PEM:

- Enhanced cumulation options
- Enhanced transshipment and distribution options
- Prohibition of drawback is eased up to a certain limit
- PEM ROO are under revision thus UA exporters will be able to implement the latest set of rules directly
- Ease of negotiation of FTAs in the Mediterranean – ROO don't need to be addressed