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MAKING EU TRADE AGREEMENTS WORK

THE ROLE OF RULES OF ORIGIN

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PAUL BRENTON AND MIRIAM MANCHIN*

Abstract

A key element of the EU's free trade and preferential trade agreements is the extent to which they *deliver* improved market access and so contribute to the EUs foreign policy objectives towards developing countries and neighbouring countries in Europe, including the countries of the Balkans. Previous preferential trade schemes have been ineffective in delivering improved access to the EU market. The main reason for this is probably the very restrictive rules of origin that the EU imposes, coupled with the costs of proving consistency with these rules. If the EU wants the 'Everything but Arms' agreement and free trade agreements with countries in the Balkans to generate substantial improvements in access to the EU market for products from these countries then it will have to reconsider the current rules of origin and implement less restrictive rules backed upon by a careful safeguards policy.

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Executive Summary

Free trade and preferential trade agreements are a major element in EU foreign policy and are at the forefront of EU policy towards developing countries and neighbouring countries in Europe, including the countries of South-east Europe. For the EU, free trade agreements are a means of increasing economic integration through improved access to the EU market, which is seen as important in achieving other political, foreign policy and security objectives. This entails that a key element of the EU's free trade and preferential trade agreements is the extent to which they *deliver* improved market access.

Information on the implementation of the EU's preferential scheme of access for developing countries, the GSP, shows that only one third of EU imports from developing countries which were eligible for preferences actually entered the EU market with reduced duties. This primarily reflects the treatment of textiles and clothing products, which accounted for over 70 per cent of EU imports from countries covered by the GSP but where the utilisation rate (the ratio of imports receiving preferences to eligible imports) was only 31 per cent. Clothing is of particular importance to developing countries, providing a base for industrialisation and participation in the world economy, and is a major export from many of the Balkans countries. For example, in 1998, almost 84 per cent of total Albanian exports to the EU were eligible for preferential treatment under the GSP yet only 2 per cent of these exports were actually granted preferential access. Similarly, it appears that many of the preferences made available by the EU to Balkans countries in recent years have not been utilised.

Understanding the reasons for this failure of preferential trade partners to benefit from GSP preferences and duty reductions on textiles and clothing products is important in assessing the extent to which the free trade provisions of the 'Everything but Arms' agreement and the stabilisation agreements with the Balkans countries will actually deliver improved access to the EU market. If factors which prevented the utilisation of GSP benefits and other preferences remain under these agreements then the direct effect

upon exports from the 49 least developed countries and the Balkans region is likely to be very muted, which will in turn comprise the foreign policy objectives of the EU towards these countries.

This paper argues that one of the key factors underlying the difficulties in obtaining preferential access to the EU is the specific rules, and particularly the rules of origin, which the EU attaches to all of its trade agreements. Rules of origin define the conditions that a product must satisfy to be deemed as originating in the country from which preferential access to the EU is being sought. The main justification for rules of origin is to prevent trade deflection, whereby products from non-participating countries destined for the EU market are redirected through free trade partners of the EU to avoid the payment of EU customs duties. However, rules of origin can be very restrictive, particularly when they define technical procedures that must be satisfied. For example, in the clothing sector the EU rules of origin stipulate a double step processing requirement whereby clothing products must be made from domestically produced fabrics or fabric from EU countries. Clothing produced from fabric imported from third countries will not satisfy the EU rules of origin and will not receive preferential treatment.

It is clear that the products exported by many preferential trade partners of the EU are unable to meet the very strict requirements of the highly technical rules of origin that the EU stipulates. This minimises the value of any preferences that the EU makes available to these countries. The restrictiveness of satisfying rules of origin is also compounded by the costs of actually proving origin. The costs of proving origin involve satisfying a number of administrative procedures so as to provide the documentation that is required and the costs of maintaining systems that accurately account for imported inputs from different sources to prove consistency with the technical rules. The ability to prove origin may well require the use of, what are for small companies in developing and transition economies, but not for companies in the EU, sophisticated and expensive accounting procedures. The costs of proving origin may be even higher, and possibly prohibitive, in countries where customs mechanisms are poorly developed. Thus, even if producers can satisfy the EU's rules of origin, in terms of meeting the technical requirements, they may not receive preferential access to the EU because the customs authorities do not accept their proof of origin or the costs of proving origin are high relative to the duty reduction that is available.

The difficulties in satisfying the origin rules of the EU are also shown by the continued prevalence of outward processing trade (OPT) between the EU

and the Central and Eastern European countries. These countries now have duty free access to the EU market so that the fiscal incentives for OPT have been removed. It would appear that companies continue to bear the administrative costs of the OPT schemes to avoid difficulties in satisfying the rules of origin in the free trade agreements with these countries. Interestingly, there is very little outward processing from the EU to Turkey, a country which is similar to the Central and Eastern European countries in terms of relatively low labour costs and proximity to the EU. Turkey, however, has a customs union agreement with the EU, in which there is no need for rules of origin due to the common external tariff.

So, at best the nature of the rules of origin that the EU imposes upon free trade partners ensures that producers in these countries are locked in to using high cost inputs from the EU if they wish to benefit from reduced tariff barriers on their exports to the EU. This clearly reduces the value of the tariff concessions. However, the restrictiveness of the rules of origin make it very difficult for companies in these preferential partners to actually obtain duty reductions and improved market access. Thus, with current rules of origin the 'Everything but Arms' agreement and free trade agreements with the Balkans countries will deliver far less than duty free access for all exports to the EU from these countries.

In this light we make the following recommendations:

- The EU should monitor the extent to which all of its trade agreements actually deliver improved market access to partner countries. This is crucial if economic integration is to play the role envisaged for it in the EU's foreign policy towards developing countries and regions such as the Balkans.
- The EU should make available information on the amount of tariff revenue collected on imports from preferential and free trade partners. Such funds should be added to the technical assistance budget for each country.
- There should be a complete reconsideration of the explicit rules of origin in EU trade agreements. The EU should consider at least implementation of a one step rule for clothing products together with a sensible safeguards policy. Ideally, the simple change of tariff heading rule should be applied to all products.
- Attention should be given to the administrative costs for companies of proving origin. A simpler and less demanding system would make it

easier for small companies in developing and transition countries to actually gain preferential access to the EU market.

- The Balkan countries and developing countries should bear in mind the potential restrictive nature of rules of origin when devising their own free trade agreements.
- In Europe a quick move towards less restrictive pan-European rules of origin should be implemented.
- In the Balkans, careful consideration should be given to the benefits of establishing a customs union with the EU, which will avoid the problems addressed in this paper.

Introduction[1]

Free trade and preferential trade agreements are a major element in EU foreign policy and are at the forefront of EU policy towards developing countries and neighbouring countries in Europe, including the countries of South-east Europe. As Pelkmans and Brenton (1998), amongst others, note, economic factors are often only one of many which propel the EU towards such agreements. This reflects that free trade partners are often economically very small relative to the EU. For free trade partners, on the other hand, improved access and security of access are key elements in the desire for an agreement with the EU. For the EU, free trade agreements are a means of increasing economic integration through improved access to the EU market, which is seen as important in achieving other political, foreign policy and security objectives. This entails that a key element of the EU's free trade and preferential trade agreements is the extent to which they *deliver* improved market access.

This paper argues that the degree of improved market access, in terms of the amount of a country's exports to the EU which are actually granted favourable treatment, delivered by current EU trade agreements is much less in practice than on paper. This is not a new finding, but very little or nothing has been done to try and change this situation. So, for example, it is clear that the much vaunted 'Everything but Arms' agreement with the 49 least developed countries will not deliver duty free access for all exports from these countries to the EU. Similarly, trade preferences and free trade agreements with the Balkans countries, as a means to promote stability and integration, will not provide for all exports from these countries to enter the EU market free of duties. In fact it is quite possible that a free trade agreement will have very little impact on access to the EU market for the majority of a partner country's exports to the EU. It is agreements with these two groups of countries that are the focus of this paper, due to their current importance in EU foreign policy. The arguments are, however, equally pertinent to the recent agreements with South Africa and the revised Meds agreements and prospective agreements with Ukraine, Russia and Moldova on the soon to be enlarged EU's Northern borders.

We argue that the EU should adopt a more rigorous approach to monitoring whether its objectives with regard to free trade agreements are actually being

[1] We are very grateful for the comments of Daniel Gros and Nicholas Whyte. This work was undertaken as part of a project on regional integration in the Balkans organised by the WIIW in Vienna.

met, and, in particular, whether the agreements are actually fostering economic integration and increasing access to the EU market. We show that the precise impact of a free trade or preferential trade agreement, especially for small countries that have a narrow industrial base, depends very much upon the detailed rules that the EU imposes to govern eligibility for preferential treatment. These rules are very strict in key sectors for the developing countries and countries in the Balkans, such as textiles and clothing and footwear, and severely limit the amount of exports from these countries that receive improved access to the EU market. It is clear that what matters is not just the level of border barriers but the rules that govern the way they are administered. Unfortunately, there is little transparency or discussion of the latter, discussion is too often avoided on the grounds that these are technical matters, whereas in practice such rules can be just as restrictive as tariff barriers.

Making Free Trade Agreements Work: Attention at the Border

The Effectiveness of the GSP

How will Stabilisation or free trade agreements promote market access and economic integration between the Balkans and the EU? If they do little to improve access to the EU market then they will contribute little to the EU's foreign policy objectives for the region. How will the 'Everything but Arms' agreement improve the treatment of exports from the partners countries in the EU? To address this issue we look at previous EU preferential trade policies towards developing countries and some of the countries in the Balkans region. The EU has had a scheme of preferences for developing countries since 1971 known as the Generalised System of Preferences (GSP).[2] Prior to the signing of stabilisation agreements with the EU, some countries in the Balkans had preferential access to the EU under the GSP. Albania had full access to GSP preferences whilst the former republics of Yugoslavia have had preferential access only for certain agricultural products since 1996 but also had special treatment for textiles and clothing products under different arrangements.

The GSP is a scheme that allows for duty reductions on certain products from particular countries subject to the products meeting the requirements stipulated by the EU, which we will discuss in more detail below. A new GSP scheme has recently been agreed for the period starting in 2002. Here

[2] The GSP is the only trade scheme under which the EU makes public information on eligibility for preferences and the actual granting of preferential access to the EU market.

we look at information regarding the previous scheme. The key issue is that the rules governing eligibility for preferences under both the old and the new scheme are very similar. Products under the old GSP were classified according to four headings according to the extent of duty reductions. In effect there was a fifth category, products which are excluded and receive no preferential treatment. The four groups were: very sensitive, where the duty applicable was 85 per cent of the MFN rate; sensitive, which had an applicable duty of 70 per cent of the MFN rate; semi-sensitive, with a duty of 35 per cent of the MFN rate; and non-sensitive, where products entered duty free.[3]

For the GSP scheme in aggregate in the year 1999 only one third of EU imports from developing countries which were eligible for preferences actually entered the EU market with reduced duties. This primarily reflects the treatment of textiles and clothing products, which accounted for over 70 per cent of EU imports from countries covered by the GSP but where the utilisation rate (the ratio of imports receiving preferences to eligible imports) was only 31 per cent. It is worth noting here that the coverage rate of the EU scheme is very comprehensive, over 99 per cent of imports from developing countries of products that are subject to duties in the EU are eligible for preferences. The striking feature of the EU scheme is the low utilisation of these preferences. The US scheme in contrast has a much higher utilisation rate (over 76 per cent in 1998) but is much less comprehensive in terms of coverage (only 53 per cent of dutiable imports from developing countries are eligible for preferences). This is because textiles and clothing products are essentially excluded from the US scheme. They are included in the EU scheme but only a small proportion of imports covered actually receives any preferences.[4]

The overall impact of the two schemes appears similar. In the EU scheme around 33 per cent of dutiable imports from developing countries receive preferential treatment, whilst 41 per cent of US dutiable imports from developing countries are actually granted preferences, although if mineral products (mainly fuel oils) are excluded from the US scheme (fuel oils face a

[3] Under the new GSP scheme products are grouped in two categories, non-sensitive and sensitive products. Non-sensitive products are suspended from tariff duties. For sensitive products a flat rate 35 per cent reduction on the MFN duty rate is granted. Specific duties are reduced by 30%, however if duties on sensitive products include ad valorem duties and specific duties, the specific duties are not reduced. Where preferential duty rates provide a higher tariff reduction, they should continue to apply.

[4] The information here comes from UNCTAD (2001).

zero duty in the EU) then only 4 per cent of dutiable imports from developing countries receive preferential treatment in the US.[5] Hence, in practice the EU and the US GSP schemes have only been delivering improved market access to a minority of imports from developing countries. The US scheme has provided virtually no preferential access for manufactured products made in developing countries.

For developing countries in general the textiles, clothing and footwear sectors are key sectors which provide the base for industrialisation and participation in the global economy. This is because production in these sectors is based upon the intensive use of labour, which is relatively cheap in developing compared to developed countries. Clothing and footwear appear to be of particular importance in the globalising economy of the 21st century. The establishment of a clothing sector does not require massive capital investment by firms or particularly large investments in infrastructure by governments, relative to other sectors such as machinery or chemicals. Further, the fragmentation of production of these sectors in OECD countries and the outsourcing of low-skilled labour activities, such as the making-up of articles of clothing, to low wage locations offers the opportunity for developing countries to effectively participate in trade.

Clothing was classed as a very sensitive product in the earlier GSP scheme and thus a reduction of only 15 per cent of the applied tariff was applicable. Nevertheless, given that the average EU tariff on clothing is around 12 per cent the GSP scheme potentially offered a significant transfer, and important source of hard currency, to the exporting country. However, as noted above only about one third of the preferences that were available to developing countries were actually taken up. Under the new EU GSP scheme developing countries exports of textiles and clothing products to the EU are eligible for a 35 per cent reduction on the MFN rate. The extent to which this new scheme will benefit the developing countries will depend very much on the extent to which the available preferences are actually taken up or whether the conditions that prevented the take up of preferences under the old scheme remain under the new GSP.

[5] UNCTAD (2000).

Table 1. The Extent of Preferential Treatment (GSP) of EU Imports from Albania [6]

Clothing (CN 61-63)					
Period	EU imports(in 1000 Euro)	% of total imports from Albania	Eligible	Granted	% granted
1998	74596.0	34.5	74841.3	1980.1	2.6
1997	57719.0	30.2	57176.2	7465.2	13.1
1996	56443.0	28.6	56315.7	964.9	1.7
1995	43568.0	28.8	43592.2	2840.9	6.5
1994	25508.0	20.8	25588.2	1388.0	5.4
Footwear (CN 64)					
Period	EU imports(in 1000 Euro)	% of total imports from Albania	Eligible	Granted	% granted
1998	63981.0	29.6	63928.5	960.7	1.5
1997	51047	26.7	51055.29	1479.75	2.90
1996	60637.0	30.7	60502.98	1030.73	1.70
1995	34187.0	22.6	34067.3	764.9	2.2
1994	35078.0	28.6	34818.2	973.3	2.8

Source: European Commission.

For all the Balkan countries clothing products are a major export category, accounting for over one third of total exports to the EU of Macedonia, Bosnia-Herzegovina and Albania and one quarter of Croatian exports to the EU in 1998. Table 1 shows for Albania the extent to which exports of clothing and footwear, which comprise over two-thirds of exports to the EU were eligible for GSP preferences between 1994 and 2000 and the extent to which those products actually benefited from lower duties in the EU market. It is striking that the GSP has had almost no effect in delivering improved market access to the EU for Albania for these products. Because of the importance of these products to Albania this entails that the GSP had very little impact on Albania's exports to the EU in total. In 1998, almost 84 per cent of total Albanian exports to the EU were eligible for preferential treatment under the GSP and only 2 per cent of these exports were actually granted preferential access, hence only a very small share of the total amount of exports eligible for GSP preferences actually entered the EU market at a preferential rate.

Table 2 shows the utilisation of GSP preferences for textiles and clothing products by Central and Eastern European countries in the early 1990s. For

[6] The coverage of the GSP for Albania was limited to agricultural products from July 1999, and it was replaced by exceptional trade measures for countries and territories participating or linked to the EU's Stabilisation and Association process (Council Regulation No 2007/2000) from September 2000.

all countries, with the exception of Bulgaria, only about 10 per cent of products eligible for duty reductions actually entered the EU market at a preferential rate. For Bulgaria around one fifth to one quarter of eligible products received preferential treatment. Thus, even for countries such as Hungary, at much higher levels of income and development, the utilisation of available preferences in 1992 was very low.

Table 2. EU Imports of textiles and clothing under GSP, in €1000 (within the brackets imports which obtained preferences in percentage)

		1992	1991	1990
Romania	Eligible	387585	290406	293092
	Granted	21626 (5.6)	19922 (6.9)	9745 (3.3)
Bulgaria	Eligible	193722	111052	-
	Granted	49480 (25.5)	19865 (17.9)	-
Hungary	Eligible	903904	542242	452365
	Granted	11976 (1.3)	64721 (11.9)	49095 (10.9)
Czechoslovakia	Eligible	653014	477234	-
	Granted	30030 (4.6)	67250 (14.1)	-
Poland	Eligible	1102773	861203	588784
	Granted	18105 (1.6)	94096 (10.9)	63818 (10.8)

Source: European Commission.

Western Balkan countries (Albania, Bosnia and Herzegovina, Croatia, Kosovo and Macedonia) have, since 2000, been offered improved autonomous trade preferences by the EU including exports of textiles and clothing products. Limited and specific trade preferences were also made available in 2000 for particular industrial products originating in the Federal Republic of Yugoslavia. Certain textiles and clothing products can be exported to the EU free of duty up to specified quantitative limits. Although we do not have data about to the extent to which imports from these countries have benefited from these preferences, it appears that the majority of trade has taken place under another scheme, outward processing, which we discuss in more detail below. Table 3 shows the amount of normal imports and the ceilings in aggregate for textiles and clothing products (products can enter duty free up to the ceiling level). It is interesting that imports did not reach the ceilings. At the same time imports under the normal outward processing scheme were significantly higher than imports under the preferential scheme for almost all product categories. This suggests that many companies chose the OPT scheme instead of benefiting from preferences using normal imports.

Table 3. Ceilings and actual imports of textiles and clothing under EU preferential schemes with Balkan countries for the year 2000

	clothing (in pieces)		textiles (in tonnes)	
	Ceiling	Imports	Ceiling	Imports
Albania[7]	4538	1375.9		
Bosnia-Herzegovina	2949.9	1267.5	5916.6	157
Croatia	6883.3	2911.3	13805.5	1293
Serbia Montenegro	2790	476.7	6405	126

Understanding the reasons for this failure to benefit from GSP preferences and duty reductions on textiles and clothing products is important in assessing the extent to which the free trade provisions of the 'Everything but Arms' agreement and the stabilisation agreements with the Balkans countries will actually deliver improved access to the EU market. If factors which prevented the utilisation of GSP benefits and other preferences remain under these agreements then the direct effect upon exports from the 49 least developed countries and the Balkans region is likely to be very muted.

The Role of Rules of Origin

So why have producers in developing countries, Balkans producers or EU importers not been exploiting the incentives of the GSP or the preferential access for textiles and clothing products for the Balkans countries? We believe that if these preferences were costlessly available then they would be fully exploited. Economic operators are notoriously good at exploiting available incentives. Thus, there must be cost-raising factors or structural impediments which are constraining the uptake of such benefits.

One of the key factors underlying the difficulties in obtaining preferential access to the EU is likely to be the specific rules, and particularly the rules of origin, which the EU attaches to all of its trade agreements. Rules of origin define the conditions that a product must satisfy to be deemed as originating in the country from which preferential access to the EU is being sought. The main justification for rules of origin is to prevent trade deflection, whereby products from non-participating countries destined for the EU market are redirected through free trade partners of the EU to avoid the payment of EU customs duties.[8] Similar reasoning applies to the need for rules of origin in

[7] For Albania product categories 6211 and 6305 are excluded.

[8] The incentive for trade deflection is obviously greater the higher are tariffs. If additional transport costs, administrative burdens and the costs of risk and uncertainty outweigh the costs of the tariff then there will be no trade deflection. Unfortunately, there has been no

the EU's free trade partner. When products are produced in a single stage then the origin of the products should be relatively easy to establish. Proof that the product was produced in the free trade partner should be sufficient. For all other cases the rules of origin define the methods by which it can be ascertained that the product has undergone sufficient working or processing in the free trade partner to qualify for preferential access. The specification of rules of origin has become particularly important in recent years as technological progress and globalisation have led to the increasing fragmentation of the production process into different stages or tasks which are undertaken in different locations.[9] In practice the higher the level of working that is required by the rules of origin the more difficult it is to satisfy those rules.

A number of general approaches to determining origin are available. The simplest way of defining origin is probably change of tariff heading, alternatively there can be rules relating to the amount of domestic value-added or to specific technical requirements that the product may satisfy. In the EU's bilateral trade agreements the basic rule that it adopts is that of the change in tariff heading at the 4-digit level of the Harmonised System of tariff classification. However, in a very large number of cases this basic rule is supplanted by often restrictive specific requirements. These other requirements can be a minimum percentage of local value added in the originating country, or a technical requirement which requires that the product undergoes specific manufacturing operations in the country.

For example, with the basic rule of change in tariff heading, a country which imports woven cotton fabric (HS 5208) to produce cotton shirts (6105) would satisfy the rule of origin and qualify for preferential reduction of the tariff on cotton shirts. However, in this specific case in EU free trade

systematic analysis of the extent to which trade deflection is, or could be, a significant problem for the EU. One would suspect that with EU tariffs for industrial products now historically very low (textiles and clothing products are exceptions) trade deflection is much less of a problem than in the past. Moreover, EU tariffs for textiles and clothing products are generally lower than the relevant tariffs in developing countries and Balkan countries. Also, the administrative costs and risks of shipping products into the EU via developing countries and the Balkans are likely to counter any fiscal incentives for such trade deflection. Trade deflection may also arise to avoid quantitative restrictions in the EU, such as those under the Agreement on Textiles and Clothing for example. This reason for trade deflection will be removed with the abolition of all such quotas at the end of 2004.

[9] See, for example, Feenstra and Hanson (2001).

agreements the change of tariff classification is replaced with a requirement that the product have been manufactured from Yarn. In effect this imposes the requirement that two stages of production must be undertaken in the partner or qualifying area to confer origin – not only the sewing together of the fabric but also the production of the fabric itself! Clothing products made in free trade partners of the EU but which are made-up of fabrics imported from third countries, such as China, will not satisfy the EU origin rules and will not qualify for tariff reduction.

The rules of origin defined by the GSP, the Europe Agreements, the Stabilisation and Association Agreements and by the regulations on autonomous trade preferences to Western Balkan countries are almost identical. The agreements state a general change of tariff heading rule, however, annexes specify, for listed products, requirements other than change in tariff classification. The value-added criterion is very rarely applied, the specific requirements listed in the annex mainly define technical requirements. These annexes typically stretch to over 80 pages, although the scope of technical requirements is even greater than this suggests since in certain cases (for example, Chapter 60 – knitted or crocheted fabrics) a specific technical requirement is set for the whole chapter.

The technical requirements defined in the annexes are more specific and more restrictive than the change in tariff heading rule. In the case of textile, clothing and footwear, the annex never specifies value-added requirements, it only lays down technical requirements. In the case of textiles, only 14 per cent of the product headings require a change in heading to satisfy origin, while the remaining 86 per cent must meet specific technical requirements to qualify for preferential access. In the case of clothing, for 95 per cent of the products the rules do not permit change of heading but require specific working and processing. Similarly for footwear, most of the products have to fulfil technical requirements. Hoekman (1993) notes that as these rules become technical they offer scope for the participation of industries in setting restrictive rules of origin.

The rules of origin in the GSP relating to textiles and clothing are very similar to those in the EU's free trade agreements including those with the Central and Eastern European Countries – for example, to qualify for duty reductions, clothing products must be made from yarn. An example of the restrictiveness of these rules has been the request, and the granting (up to a quantitative limit), of a derogation from the rules of origin by Lao PDR, Nepal and Cambodia. In 1997 only 6 per cent of Lao textile and clothing exports to the EU benefited from GSP duty exemption (Lao PDR is

classified as a least developed country and is eligible for duty free access to the EU market for many industrial products). The Commission accepted that the Lao textile and clothing industry was unable to satisfy the EU rules of origin.[10] Thus, the 'Everything but Arms' agreement with the same rules of origin as the GSP is unlikely to deliver any substantial improvement in access to the EU market for clothing products from countries such as Laos.

It is rules of origin, such as those discussed above, which underlie the analyses of Krueger (1995) and Krishna and Krueger (1995) who demonstrate how rules of origin can act as 'hidden protectionism' and induce a switch in demand in free trade partners from low-cost external inputs to higher-cost partner inputs to ensure that final products actually receive duty free access. With the apparent aim of preventing trade deflection, rules of origin can be used to protect a domestic industry from unwanted competition based in the partner, even in conditions where trade deflection is unlikely (Falvey and Reed (1998)). Note that in this situation the EU is unlikely to exert pressure on the trade partner for the general liberalisation of tariffs against other trading partners. James (1993) argues that as the degree of protection offered by the common external tariff in the EC has diminished increasingly restrictive rules of origin have become commonplace.

Thus, for example, in small developing countries where there is no domestic textile industry but a competitive clothing industry, clothing producers will be faced with the choice of importing fabrics from the EU[11] and therefore satisfying the EU origin rules and receiving preferential access to the EU market or importing fabrics from a non-qualifying source and having to pay the full duty. This choice will be influenced by the tariff in the EU on the final product and the country's tariff on imported fabrics. If clothing producers in the country are induced to shift from a third country source to an EU source of fabrics there will be trade diversion (fabrics will be imported from a less efficient source and there will be a loss of tariff revenue) which will offset any gains from improved access to the EU market for the final clothing product. Given the importance of the textiles and

[10] See http://www.deltha.cec.eu.int/newsroom/background/nglish/Lao_textile_exports_to_the_EU.asp)

[11] Given the importance of rules of origin an important element that affects the pattern of trade flows is the extent to which the agreement allows diagonal cumulation across other free trade or preferential trade partners. In the GSP there is limited regional cumulation. For the stabilisation agreements in the Balkans there is no regional cumulation, only bilateral cumulation with the EU is allowed.

clothing sectors and that the rules of origin in EU trade agreements may stimulate such trade diversion, it is possible that such agreements will actually reduce economic welfare in developing country partners and partner countries in the Balkans!

The restrictiveness of satisfying rules of origin may also be compounded by the costs of actually proving origin. In a widely quoted study Herin (1986) found that the costs for EFTA producers of proving origin led to one quarter of EFTA exports to the EU paying the applied most favoured nation (MFN) duties. The costs of proving origin involve satisfying a number of administrative procedures so as to provide the documentation that is required and the costs of maintaining systems that accurately account for imported inputs from different sources to prove consistency with the technical rules. The ability to prove origin may well require the use of, what are for small companies in developing and transition economies, but not for companies in the EU, sophisticated and expensive accounting procedures. Without such procedures it is difficult for companies to show precisely the geographical breakdown of the inputs that they have used.

The costs of proving origin may be even higher, and possibly prohibitive, in countries where customs mechanisms are poorly developed. Thus, even if producers can satisfy the EU's rules of origin, in terms of meeting the technical requirements, they may not receive preferential access to the EU because the customs authorities do not accept their proof of origin or the costs of proving origin are high relative to the duty reduction that is available.[12] The latter suggests that the economic impact of preferential tariff reduction may be discontinuous. Initial reductions in tariffs will have little impact since they will be less than the costs of proving origin. It is only once the gap between the preferential tariff and the MFN rate exceeds the costs of proving origin that there will be a stimulus to trade. However, as we will discuss below even with free trade agreements the difficulties and costs of proving origin may preclude duty free access to the EU.

The World Bank and the European Bank for Reconstruction and Development jointly developed a Business Environment and Enterprise

[12] This is exacerbated by the fact that the EU can act retrospectively and demand proof of origin in years after the export was actually made. For example, 15308 certificates of origin for textiles and clothing products issued over between 1994 and 1996 were found not to be in conformity with the relevant EU origin rules and full duties were re-imposed. This reflected a 'failure to understand and properly apply the complex "double jump" provision' UNCTAD (2001).

Performance Survey (BEEPS). The survey is based on face-to-face interviews with firm managers and owners. The questionnaire included the following question: "how problematic are customs/foreign trade regulations for the operation and growth of your business?". The answers suggest that these regulations still constitute important obstacles, especially for small companies, where the number of employees was between 1-49. For example, in Croatia only 39 per cent of firms said that these regulations generated no obstacles, in Albania only 15 per cent, in Bosnia and Herzegovina the same figure was 31 per cent while in Macedonia it was 23 per cent.[13]

Rules of Origin and Outward Processing Activities

Further evidence that rules of origin and the costs of origin are important comes from the importance of outward processing traffic (OPT) and interestingly the fact that for Europe Agreement countries OPT activities have continued even after the complete removal of tariffs. OPT has been an important feature of the development of trade between the EU and the countries of Central and Eastern Europe and is equally, if not more, important for countries in the Balkans. OPT in textiles and clothing may have been initially stimulated in the early 1990s by the presence of quotas imposed under the Multi Fibre Agreement or bilaterally imposed by the EU. However, few of those quotas actually appeared to be binding.[14]

Under normal or fiscal OPT procedures, EU trade policy encourages processing overseas by EU firms by providing relief from import duties on the compensating value of imports after processing abroad. The amount of duty payable is calculated from the value of the product imported multiplied by the appropriate tariff for that product minus the hypothetical duty that would have been paid on the intermediate products exported under the processing scheme, that is the value of the exports for processing abroad multiplied by the appropriate EU tariff for that product. Thus, an EU firm which exports textiles under an OPT scheme and re-imports clothing products would have to pay the duty on the clothing product but would be refunded the duty that would be applicable to the value of the textile products exported.

[13] The results of the questionnaire can be find in http://info.worlbank.org/beeps/front.htm

[14] In 1995 none of the Central and Eastern European countries were subject to strongly binding quotas (defined when imports exceed 95 per cent of the quota level) and only the Czech Republic was subject to weakly binding quotas (imports greater than 80 per cent of the quota level). In 2000 both Croatia and Serbia were subject to strongly binding clothing quotas.

Within outward processing in textiles and clothing the EU has provided for a specific scheme known as "economic outward processing" where, often up to specific limits and/or subject to surveillance, imports after processing enter the EU duty free. Economic outward processing was introduced to "enable the textile and clothing industry to adapt to the conditions of international competition".[15] Under this regime, goods temporarily exported from the EU for processing must be in free circulation within the Community and must have EU origin. Although, if products of Community origin are insufficient, derogation can be granted from these rules, but for no more than 14% of the total value of the goods for which prior authorisation is requested. There are further requirements in the regulation to protect the industry in the Community, such as, commitments to maintain production and employment in the Community and maximum processing rules. The latter are the converse of the rules of origin in free trade and preferential trade agreements, which stipulate minimum processing requirements.

Furthermore, the economic outward processing procedure should only be applied if there are quantitative limits or surveillance with regard to imports of textile and clothing products from the country where the processing would take place. However, for the Czech Republic, the Slovak Republic, Hungary, Poland, Romania and Bulgaria the procedure was applicable for products even when there were no import limitations or specific measures. Imports after economic outward processing for these countries could enter to the EU with zero duties.

Table 4 shows the importance of products that have been processed abroad in EU imports of clothing from Balkans and Central and Eastern European countries in 1998 and 2000. For Albania and Serbia the vast majority of clothing exports to the EU, 92 per cent and 85 per cent respectively, had involved the processing of EU inputs under an outward processing scheme. For Bosnia, Croatia and Macedonia around one half or more of clothing exports to the EU had been part of an OPT operation for an EU company. Overall between ten and 20 per cent of EU imports from Macedonia, Bosnia and Croatia have involved the processing of temporarily exported EU inputs, whilst nearly two-thirds of EU imports from Albania were after outward processing. Hence, outward processing, particularly of clothing and footwear products is an important feature of EU trade relations with the Balkans countries.

[15] Council Regulation No 3036/94, p.1.

Table 4. Importance of economic OPT and fiscal OPT in EU exports of textiles and imports of clothing

Share of EU imports of clothing after processing abroad						
	2000			1998		
	Total OPT	Economic OPT	Fiscal OPT	Total OPT	Economic OPT	Fiscal OPT
Turkey	0.5	0.1	0.4	1.5	1	0.5
Romania	33.6	7.1	26.5	51.8	13.7	38.1
Bulgaria	46.2	6.6	39.6	51.4	9.9	41.5
Albania	92.1	23.1	69	94.3	19.6	74.7
Croatia	54.4	23.9	30.5	60.6	21.6	39
Bosnia-Herzegovina	49.4	13.5	35.9	66.8	22.6	44.2
Serbia-Montenegro	85.0	25.3	59.7	83.9	20.9	63
FROM	58.8	13.9	44.9	61.1	17.3	43.8
Poland	35.5	6.9	28.6	57.0	9.4	47.6
Slovakia	18.2	6.3	11.9	49.4	11	38.4
Hungary	40.7	21	19.7	47.6	11.3	46.3
Slovenia	28.8	5	23.8	57.8	14.4	43.4
Czech Rep.	25.8	7.4	18.4	39.7	9	30.7

It is also informative to look at the evolution of OPT for those countries which now have duty and quota free access to the EU market through the Europe Agreements. In 2000 imports after outward processing accounted for over 35 per cent of EU imports of clothing from Poland, over 40 per cent of EU imports from Hungary, 34 per cent from Romania and more than 45 per cent from Bulgaria. EU tariffs on imports of clothing from Poland, Hungary, Bulgaria and Romania were removed in 1997. So why should EU companies incur all the administrative costs associated with registering for outward processing in products where they should be able to import the final product free of duties?

We postulate here that the cost of paying the full duty on the imported clothing products minus the duty that is calculated on the exported inputs is less than the costs of proving origin (including the risk that even valid documents are rejected at the customs point) or that origin cannot be proved due to the strict nature of the rules of origin. If this is the case then OPT amongst preferential trade partners is a mechanism for reducing duty payable without having to incur the costs of proving origin or is a mechanism for avoiding having to prove origin. This argument is supported by the data for Turkey, which shares many of the features of the countries in this region, in terms of relative labour costs and comparative advantage in the production of clothing products. A notable difference, however, is that Turkey has signed a

customs union agreement with the EU, under which, due to the common external tariff, there is no need to prove origin. Outward processing between the EU and Turkey is negligible.

Hence, EU bilateral trade policies, particularly with regard to the textiles and clothing sectors, act as a mechanism to lock partners into the processing of EU inputs and where this is not feasible preferential access is prevented. Restrictive technical rules of origin ensure that clothing products produced in partners from third country fabrics do not qualify for preferential treatment. For neighbouring countries the restrictiveness of the rules of origin and the costs of proving conformity with those rules can be overcome by participation in the outward processing schemes established by the EU. For developing countries that are further away even this does not seem to be a practical option. Nevertheless, whilst it may be in the interest of the industry in the EU to participate in these processing operations it is not clear whether it is in the best interests of the partner. Thus, an important issue for consideration in the EU should be whether these outward processing schemes are helping the EU to achieve its foreign policy objectives with regard to neighbouring countries and whether alternative policies would be more effective in stimulating trade and economic integration.

Given the apparent importance of rules of origin in influencing the economic impact of free trade areas it is of interest to look at the process of negotiation that leads to their inclusion. In fact, however, it appears that there is no process of negotiation. The EU presents its specification of rules of origin, which potential free trade partners either accept or accept! But how does the EU arrive at its specification of rules of origin? Given that economic integration is an element in achieving foreign policy objectives are these rules designed in a way to minimise any hindrance to the exports of the free trade partner? Our initial analysis suggests not: rules of origin are a significant factor in constraining exports from free trade partners of the EU. Conversely, are the rules primarily reflecting the interests of EU producers? It would be easier to assess this proposition if the process by which the EU defines rules of origin were transparent. But it is not. The information we have been able to obtain suggests that the current set of rules of origin, which are very similar across different free trade partners, are applied simply because they have been applied in the past. The exact origins of the specification of the rules of origin and their rationale are not clear but one cannot rule out that they primarily reflect the interests of particular groups of EU producers, who are quite happy to see such rules remain. There does not

appear to have been any attempt to assess whether rules of origin specified a decade or more ago are relevant to the current economic climate.

Thus, what we can conclude is that the EU imposes an existing set of rules of origin with little regard to their potential economic impact on free trade partners. UNCTAD (2001) points out that arguments concerning the restrictiveness of rules of origin have been regularly made since the inception of the GSP scheme almost 30 years ago but the rules have changed little and the problems in fulfilling the origin requirements persist. Preferential rules of origin have passed through a number of rounds of global trade talks under the GATT and then the WTO untouched and subject to no effective discipline.

Conclusions

Developing countries and the countries of the Balkans are specialised in the production of labour intensive products. The ability to increase export revenues in the short-run and to increase the degree of economic integration with the EU will be determined by export capacity and market access for products such as clothing and footwear. This is the background to the 'Everything but Arms' and the Stabilisation Agreements that the EU is signing in the Balkans region. In this paper we suggest that economic integration, which is an important element of the EU's foreign policy initiatives towards these countries, will be hampered by the nature of the administrative rules that the EU applies to implement free trade agreements. At the forefront of these are rules of origin, which govern access to preferential treatment. Preferences under the GSP have not been exploited in the past because of the difficulties of satisfying the restrictive technical rules that the EU applies to define origin and because of the actual costs of proving origin and difficulties in passing through customs.

Thus whilst the EU likes to portray its agreements with the Central and Eastern European and now the Balkan countries as asymmetric, with trade liberalisation being undertaken at a faster rate in the EU, in practice this may not be the case. At best the nature of the rules of origin that the EU imposes upon free trade partners ensures that producers in these countries are locked in to using high cost inputs from the EU if they wish to benefit from reduced tariff barriers on their exports to the EU. This clearly reduces the value of the tariff concessions. However, there is evidence to suggest that the restrictiveness of the rules of origin make it very difficult for companies in these preferential partners to actually obtain duty reductions and improved market access. In effect, to obtain improved market access requires a degree

of sophistication in terms of being able to satisfy origin rules and to prove conformity with those rules. This makes asymmetric liberalisation by the EU with relatively poorer countries difficult to achieve through preferential or free trade agreements. One way of avoiding these problems and of guaranteeing improved access to the EU market would be to sign customs unions rather than free trade agreements where rules of origin are not necessary due to a common external tariff, provided that a suitable means of allocating tariff revenues is implemented.

What could be done to reduce the restrictiveness of rules of origin in EU preferential trade agreements? Currently, the EU approach assumes that all trade partners are equally susceptible to trade deflection and so are treated in the same restrictive manner. This is clearly far too draconian. If the EU were to relax its rules of origin by, for example, requiring a single production step in the production of clothing, it is obvious that we would not see a flood of imports from third countries being re-directed through each and every one of the EU's free trade and preferential partners. There may be some propensity for trade deflection, although this is declining due to tariff reductions and the removal of quotas, but this is most likely to be concentrated on specific locations. Thus, a more targeted policy such as a carefully designed flexible safeguards policy is likely to be more effective in preventing trade deflection without constraining imports from a wide range of preferential suppliers.

In this light we make the following recommendations:

There is need for monitoring by the EU of the extent to which its trade agreements actually deliver improved market access to partner countries. This would not be difficult to achieve. Thus, under the stabilisation agreements the EU should collect statistics on the amount of imports from Balkan countries that actually receive duty free treatment. Similar provision should be made for the 'Everything but Arms' agreement. The EU has established a strong capacity for monitoring overseas market access for EU companies. It would be useful if a similar capacity were established to monitor to what extent EU offers to third countries of improved market access actually materialise, and if not, why not. This is crucial if economic integration is to play the role envisaged for it in the EU's foreign policy towards developing countries and regions such as the Balkans.

The EU should make available information on the amount of tariff revenue collected on imports from preferential and free trade partners.**16** Such funds should be added to the technical assistance budget for each country. The

[16] Despite our best efforts such information has not been provided to us.

revenue that the EU collects on imports from duty free or preferential trade partners should not enter the general EU budget.

There should be a complete reconsideration of the explicit rules of origin in EU trade agreements. For products of particular importance to the developing and the Balkan countries, where products are clearly not receiving preferential access there could be derogation from the current rules of origin. More generally, the EU should consider at least implementation of a one step rule for clothing products together with a sensible safeguards policy. Ideally, the simple change of tariff heading rule should be applied to all products.

Attention should be given to the administrative costs for companies of proving origin. A simpler and less demanding system would make it easier for small companies in developing and transition countries to actually gain preferential access to the EU market.

The Balkan countries and developing countries should bear in mind the potential restrictive nature of rules of origin when devising their own free trade agreements. In Europe a quick move towards less restrictive pan-European rules of origin should be implemented. In the Balkans, careful consideration should be given to the benefits of establishing a customs union with the EU, which will avoid the problems addressed in this paper.

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