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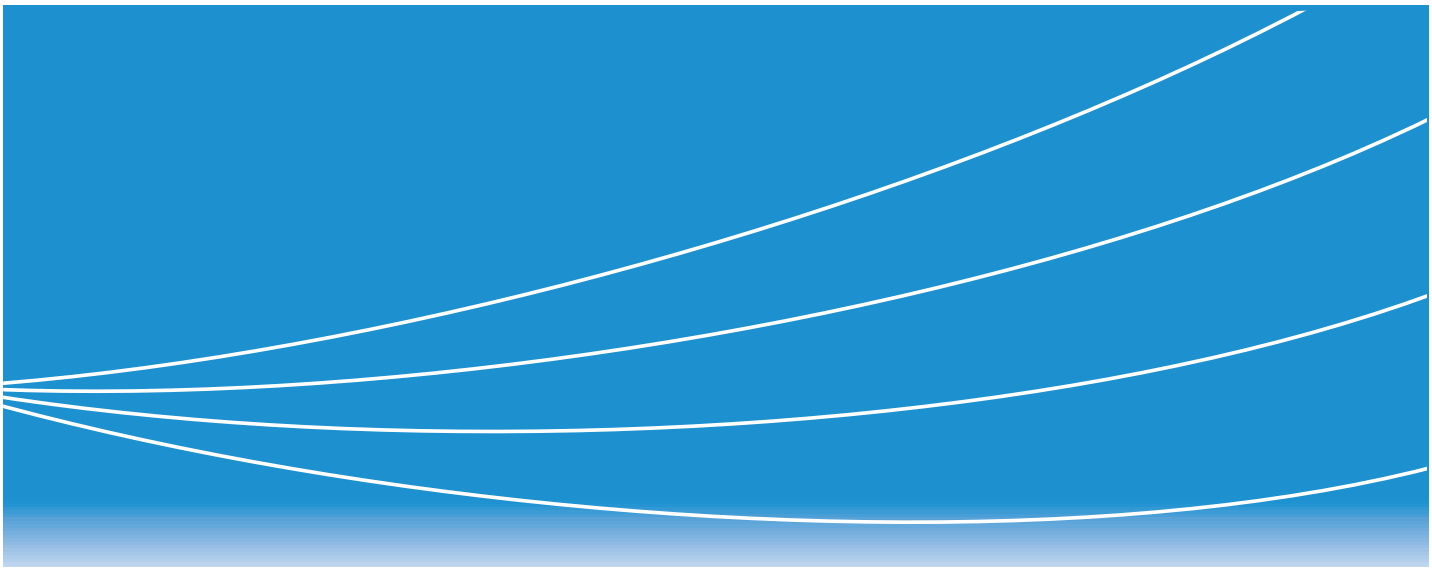
Rule of Origin for Development: from GSP to Global Free Trade



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Rules of Origin for Development: from GSP to Global Free Trade

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Abstract

Recent calls for reform of the rules of origin in preferential trade arrangements such as the GSP as well as in many free trade agreements between developed and developing countries have focused almost exclusively on the need to relax the requirements of these rules. Without fundamentally disagreeing, his paper presents some cautionary arguments with respect to the relationship between rules of origin and development, and proposes an alternative mechanism, extended cumulation, by which the problems generated by burdensome rules of origin might be alleviated without jeopardizing the development benefits for which the preferential programs were intended. In the longer-term, this approach could also alter the political economy balance within high-tariff developing countries, increasing the potential for more substantive multilateral liberalization.

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I. Introduction

The effects of the structure of the international trading system on developing countries have been a topic of discussion and debate nearly all of the postwar period. A generally accepted conclusion that has emerged from this debate is that participation in the global economy leads to higher economic growth and a reduction of poverty[1]. One of the ways that developing countries participate is by exporting to the larger, developed countries.

There are essentially three mechanisms by which exporters in developing countries gain expanded market access to developed country markets. The first mechanism is through multilateral tariff reductions in the GATT/WTO. These tariff reductions are not specifically for developing countries, but are also not generally accompanied by any conditions for access, or limits thereon. All WTO member countries benefit from these reductions.

The second mechanism by which developing countries gain access to developed country markets is, still within the context of the GATT/WTO, by way of the "enabling clause", adopted in 1971, which provides an exception to the most favored nation (MFN) principle that allows for differential, more favorable treatment for imports from developing countries in the developed countries. This gave rise to the establishment of the Generalized System of Preferences (GSP) wherein the developed countries would unilaterally grant trade preferences to developing countries without requiring reciprocal preferences from them.

These preferences are "unilateral" in the sense that their depth, scope, and limitations are not necessarily subject to any kind of negotiation with the beneficiary countries, and do not involve any reciprocal preferences from them. The preferences are set and conditioned by the grantor countries alone, and can be modified or revoked by them at any point.

This potential disconnect between the interests of the beneficiary countries and the crafting of the preferential programs, as well as the uncertainties based on the instability of a program that must be periodically renewed by legislatures in the grantor countries, has diminished the incentive to invest in productive capacity in the developing countries. Furthermore, there is much evidence that the conditions applied to the preferential access can be

[1] Sala-I-Martin (2007) summarizes much of the recent theoretical and empirical work on these links.

quite burdensome, to the extent that compliance with these conditions becomes more costly than the benefits are worth[2].

Third and finally, since the end of the cold war there has been a rapid proliferation of free trade agreements (FTA's) between developed and developing countries. These agreements among generally small numbers of countries (often only two) involve the reciprocal granting of tariff preferences. Because of this asymmetry in levels of development, the development effects of the preferences again become an important consideration.

Important arbiters of the scope of the tariff preferences, both unilateral and reciprocal, are the rules of origin. These rules consist of criteria, often very detailed, that determine the degree to which materials from non-beneficiary countries may be used in the production of goods without the latter being disqualified from the preferences. For example, the rules will stipulate whether fabric imported from a third country can be used in the production of shirts in the beneficiary, and the shirts still be eligible for preferential treatment. The rules will also specify to which third countries this applies.

These rules are fundamentally necessary for preferential trading arrangements, whether unilateral or plurilateral, to exist. Without limits on external content, these preferences would amount to a unilateral liberalization limited only by the transport costs of shipping goods through beneficiary countries (this process is known as *trade deflection*). Observing that almost no country has completely freed trade with all partners, it is clear that such unilateral liberalization is not politically feasible in the developed countries. In order to make trade preferences politically palatable in developed countries, these preferences must be targeted to the identified beneficiaries, and limited to them alone.

At the same time, these limitations on the use of materials from non-beneficiaries can increase the production costs in developing countries by an amount that exceeds the benefits of the tariff preferences granted. That is, substituting domestic, or "originating", materials for imported materials in a production process can be more expensive than it is worth, if domestic suppliers even exist. The rules of origin may thus function to significantly reduce or eliminate the value of the tariff preferences available under the scheme. This effect, well documented in

[2] See for example Carrere and de Melo (2006), Brenton and Manchin (2003) and Matoo et. al. (2003)

many cases (see for example Mattoo, Roy, and Subramanian (2003)), gives the impression that trade-preferences-for-development (TPFD) schemes are all talk and no substance.

These problems are not limited to the unilateral schemes that are explicitly designed to promote development. Many reciprocal FTAs have been targets of similar criticism; most recently the Economic Partnership Agreements (EPAs) negotiated by the EU with the African, Caribbean, and Pacific (ACP) countries to replace the Cotonou Agreement. The rules of origin of the North American Free Trade Agreement (NAFTA) have also be been criticized on these grounds[3].

Attention to this topic has grown in recent years as TPFD schemes have multiplied and, in some cases, seen unilateral preferences replaced with reciprocal agreements. Both the report of the Blair Commission for Africa and a recent European Commission white paper have emphasized the need for reform of the rules of origin and put forward ideas. On the other side of the Atlantic, debates surrounding the African Growth and Opportunity Act (AGOA) and other US TPFD schemes have raised the issue of rules of origin interfering with the stated goals of the schemes.

The importance of these issues has increased with the globalization of production processes. Kimura and Ando (2003, 2005) have extensively documented the fragmentation of many production processes across countries in East and Southeast Asia, a process that has brought investment and employment to these countries. This has been made possible by expanding economic integration of the region as well as falling applied tariffs.

In this paper we first ask: What are the rules of origin in these schemes, and how might they be made more effective for promoting development? We argue that drastic reductions in the "strictness" of the rules may be counter-productive on development grounds, and suggest instead a solution based on modifications to the cumulation provisions of the TPFD schemes. We subsequently argue that such modifications could have important implications for the global trading system. In particular such changes could, over time, lead to greater multilateral liberalization among developing countries.

[3] See Cadot et. al. (2006), among many.

While government support for agricultural production in developed countries has been often cited as the primary obstacle to progress in the Doha round of WTO negotiations, the bulk of high tariffs in the world on non-agricultural goods are applied by developing countries. Several recent studies[4] have indicated that preferential liberalization can lead to multilateral (non-preferential) liberalization. By these sorts of political-economy processes there is reason to expect that, over time, the changes suggested to the cumulation provisions in the TPFD schemes of the developed countries could lead to reduced resistance to non-agricultural market access (NAMA) concessions in the developing countries, thus facilitating global negotiations towards freer trade.

It is important to clearly distinguish two separate goals that are sought. In the context of the TPFD schemes, the goal is to promote the integration of the developing countries into world trade in such a way that encourages and accelerates their development, where we take this to mean investment in human and physical capital that expands incomes and opportunities for the impoverished. Simultaneously the members of the WTO are (or should be) seeking paths that lead to the eventual goal of the elimination of barriers to global trade. While the elimination of these barriers on an MFN basis by all countries is expected to promote development of the poorest, this latter goal is politically difficult and hence unlikely in the short run. This paper focuses on one mechanism that could make TPFD schemes better for purposes of the first goal, development, while bettering the chances for the second.

We reach two conclusions. First, a relaxation of the requirements of the product-level rules of origin in TPFD schemes will not necessarily promote development, while changes in the cumulation provisions could achieve a similar relaxation without undermining the development goals of these programs. The fundamental logic of such changes should be to allow the cumulation of any materials that would enter the grantor country duty free if exported directly. Second, such a modification of the cumulation provisions of the various TPFD schemes would shift the political economy balance within developing countries in a way that would lead them to be better disposed to engagement in multilateral tariff reductions.

Section II reviews the conceptual background for the effects of rules of origin on producers, as well as the interaction between requirements of the rules, the set of countries

[4] Estevadeordal, Fruend, and Ornelas (2007) find that there is statistical causality linking preferential liberalization to multilateral liberalization. Baldwin (2006) develops a theoretical political economy framework that leads to similar outcomes.

included in the cumulation zone, and the impact of the rules on firms' market access. Section III summarizes the relevant features of the TPFD programs of the developed countries. Section IV reviews the solutions to the rules of origin problem that have been proposed by a variety of governments, academics, and NGOs, and examines the likely development benefits of these reforms. Section V presents the logic underlying the development benefits of reforming the cumulation provisions of the TPFD rules of origin to allow the cumulation of all materials that would enter the grantor country duty-free if exported directly, and describes several levels at which such reforms could be implemented, while Section VI addresses the issue of the administrative burden of demonstrating and verifying origin that would be implied by this proposal. Section VII analyzes the probable effects of extended cumulation in TPFD programs on the political economy of MFN liberalization in the beneficiary countries, and Section VIII concludes.

II. Effects of Rules of Origin on Firms' Costs and Market Access

Before delving into the relative benefits of various proposed reforms to the TPFD programs' rules of origin, let us first be clear regarding how rules of origin work and the mechanisms by which they affect market access. This requires addressing the way rules of origin are defined, the importance of the cumulation provisions, and the interaction of these two elements in determining their impact on firms' costs[5].

There are three basic criteria types with which rules of origin may be defined: change of tariff classification (CTC), regional value content (RVC) and processing requirements. CTC rules use the product categories of the national tariff nomenclatures to identify materials used in the production of a good that may, and may not, be imported from outside the beneficiary country without that good losing access to the preferential tariffs. RVC rules specify a fraction of the value of the final good that must derive from materials produced within the beneficiary country, without specifying which particular materials may or may not be imported. Processing requirements identify particular parts of the production process that must be carried out in the beneficiary country.

Cumulation is the provision that allows materials that meet the requirements of the rules of origin in one country to be considered as originating in another when determining the

5 See Krishna (2006) for a detailed theoretical analysis of the effects of rules of origin on firms as well as on trade.

originating status of good produced using those materials in the latter. We define the set of countries from which a producer may source cumulable materials as the *cumulation zone*.

It is important to remember that rules of origin affect trade when they increase firms' production costs by causing them to substitute more costly inputs sourced within the cumulation zone for less costly inputs that are available from outside the zone. The goal of this section is to distinguish two alternative methods for reducing these costs so as to promote exports of developing countries under the TPFD schemes in a way that maximizes their development benefits.

The degree to which the rules limit the use of inputs from outside the cumulation zone we will call their *observed restrictiveness* (OR) because the restrictiveness is easily observed in the text of the rule. CTC rules that require a larger change of classification and/or identify many products that may not come from outside the cumulation zone, and RVC rules that require a large fraction of the final good's value to be derived from originating materials are considered to have higher OR.

However, the degree to which the rules affect firms' actual production costs we will call *effective restrictiveness* (ER). This is the restrictiveness that really matters, as it is the actual costs to firms of complying with the rules that determines whether they will be able to take advantage of the tariff preferences established under the TPFD programs.

The magnitude of the rules' effect on firms' costs, the ER, will depend on two fundamental factors. First, the degree to which the rule permits the use of inputs from outside the cumulation zone, the OR, and second the availability within the cumulation zone of efficiently produced (i.e. inexpensive) inputs. This means that effective restrictiveness is partly determined by observed restrictiveness, but the two are not the same, because the definition of the cumulation zone also has an effect. If the global least-cost suppliers of the relevant inputs are located within the cumulation zone, then a rule with maximum observed restrictiveness will have no effect on producers' costs, that is, zero effective restrictiveness. This is because even if the rules of origin imposed no restriction on the origin of the inputs, the producers would make the exact same sourcing choices. In the opposite sense, a seemingly lax rule that requires only one of many inputs to be sourced within the cumulation zone (i.e. with low observed restrictiveness) will have a high effective restrictiveness if no supplier of that particular input exists within the zone.

Thus the relationship between OR, cumulation zone, and ER, is the following. For a rule with a given OR, an increase in the size of the cumulation zone will not increase, and may decrease, the ER. Likewise, for a given defined cumulation zone, an increase in the OR of a product's rule will not decrease, and may increase, the ER. In mathematical terms ER is non-decreasing in OR, and non-increasing in cumulation zone[6].

The cost of compliance with rules of origin depends on Both the Requirements of the rules themselves and on the definition of the cumulation zone.

When seeking origin-related policy options for increasing the development benefits of TPFD programs, it is necessary to recall that both the observed restrictiveness of the rules and the cumulation zone are variables that policymakers may control in trying to regulate effective restrictiveness. In very general terms, a reduction of the observed restrictiveness will tend to lower compliance costs and increase imports of materials from outside the cumulation zone[7]. An expansion of the cumulation zone will also tend to reduce compliance costs as new potential suppliers become available, and increase imports of materials from inside the (extended) cumulation zone. The relative merits of these two alternative methods of reducing compliance costs will be examined in sections IV and V.

III. Existing Preferential Schemes

In this section we present an overview of the origin provisions of the different TPFD arrangements currently in place in the developed countries, and so that we may subsequently proceed to a discussion of reforms that might improve them.

EU TPFD Programs

In the European Union, the GSP is the most general, catch-all TPFD in place. The GSP is available to all developing countries, and imports under this provision generally pay 50% of the MFN tariff, though they may be subject to quota limitations. Within the EU's GSP are the GSP+ and Everything But Arms (EBA) programs which provide 100% tariff reduction for imports of

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[6] Empirically, Estevadeordal, Harris, and Suominen (2007) observed that FTAs with larger cumulation zones as measured by combined GDP tend to apply rules of origin with higher average observed restrictiveness. This can be interpreted as indicating that large countries contain more producers interested in the negotiation of rules of origin for FTAs of which they are members, or as evidence that any rule is likely to have lower effective restrictiveness if the cumulation zone is larger, or both.

[7] Relaxation of the rules of origin to permit third-country fabrics in the production of apparel articles in the least developed AGOA countries resulted in increased imports of fabrics from East Asia, primarily China (see for example Ahmad (2007)).

goods originating in least developed countries, free of any quota restrictions (i.e. Duty-Free-Quota-Free). All three of these programs currently specify the same set of rules of origin[8], which are detailed in an 86-page "list of qualifying operations"[9]. These rules for the most part are based on change of tariff classification at the heading level, though there are many deviations from this general principle.

In order for goods exported from a beneficiary country to qualify for the reduced rate of duty, any material inputs used in the production of the goods must originate in the beneficiary country, the EU, or in some cases in another beneficiary country within a regional grouping identified by the EU[10]. Any material inputs originating outside of these countries must undergo the processing specified in the list of qualifying operations and/or represent a sufficiently small fraction of the value of the final good.

Beyond these unilateral preferences, there are a series of Economic Partnership Agreements, which are reciprocal free trade agreements involving the elimination of tariffs both on European imports from EPA partners as well as of the partners' tariffs on imports from the EU. While the EPAs are not explicitly geared as trade-preferences-for-development policies as are the GSP programs, nearly all of these agreements are with low- or middle-income countries. As such, the EPAs are frequently promoted on development-promotion grounds, and so should be evaluated on the same criteria[11].

Although many of these negotiations are still being concluded and the texts are not widely available for study, the EPA's are likely to specify rules of origin that are highly similar to those of the GSP. If one analyzes the rules specified in similar agreements already in force with Mexico, Chile, and South Africa, as well as the rules for the Pan-European Cumulation System (PECS), the differences as compared to the GSP rules are very few and far between. Furthermore, with the exception of the Mediterranean countries that are members of the PECS, existing EPA-type agreements all provide only for cumulation of origin among members of each specific agreement. For example, Mexico and Chile can not cumulate with each other for purposes of exports to the EU under their respective EPA's.

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8 With very few and relatively minor deviations.

9 As published in the Official Journal of the European Union, 29 May, 2003.

10 The GSP identifies three groupings. Group I consists of nine countries in Southeast Asia, Group II of eleven countries in Latin America (essentially the CACM, Panama, and the Andean Community), and Group III of seven countries in South Asia. The currently proposed draft regulation indicates that this configuration may to change.

11 An interim origin regime is currently in place that applies to 35 ACP countries, principally the CARIFORUM countries plus 20 other ACP countries. At present, this origin regime allows for cumulation among all 35 of these countries.

US TPFD Programs

Like the EU, the US also has a GSP program. While the level of preference is the same for all countries, the product coverage is greater for LDCs. The rules of origin for the US GSP are in principle much simpler than the EU rules, requiring that 35% of the value of goods be derived from originating materials or value added in the beneficiary country, as well as that the good be a "new and different article of commerce" as compared to the imported materials[12]. These requirements are constant across products. The cumulation provisions in the US GSP, like the EU GSP, identify regional groupings of countries within which cumulation is permitted[13]. Material inputs originating from the US are also cumulable.

Additionally, the US operates several region-specific TPFD programs for the Caribbean (CBI-Caribbean Basin initiative) the Andean Community (ATPDEA), and for Africa (AGOA-Africa Growth and Opportunity Act). These programs offer broader product coverage than the GSP, as well as freedom from the Competitive Needs Limit (CNL) restrictions[14]. They also have their own rules of origin for some products, though for most products the GSP rule applies. The cumulation provisions of these agreements generally include all countries in the program.

Because of the limited utilization of the conventional GSP granted by the US, and the limited country-coverage of other explicit TPFD programs (CBI, ATPDEA, AGOA), it is helpful to consider the broader, reciprocal US FTAs as well. With the exceptions of Canada and Australia, (and depending on one's definition, Singapore, Korea, and Israel), all of the US FTAs are signed with developing countries. Thus it is reasonable to consider them as TPFD programs. A similar categorization of the EU's EPA's can be asserted. Indeed, with very few exceptions[15] one can generalize that North-North trade is regulated by the WTO tariff bindings and North-South trade by a patchwork of overlapping WTO, GSP, and FTA regulations.

In this context the US has agreements in place with Mexico, Central America, Peru, and Chile, as well as Morocco, Oman, Jordan and Bahrain. Negotiations are concluded with Panama

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12 The "new and different article of commerce" requirement has been historically been evaluated on a case by case basis. US Customs and Border Patrol (CBP) is currently seeking comments on a proposal to replace this requirement with the NAFTA marking rules, which are based primarily on CTC criteria. This would bring added transparency, and is unlikely to create new barriers, as CBP has used these rules to guide the case by case evaluations for many years.

13 These groupings were defined in the US Trade Act of 1974 and do not appear to have been modified since, except to remove countries that have graduated. These include the Andean Group, four members of ASEAN, nine members of CARICOM, six members of WAEMU, three of SADC, and six of SAARC.

14 CNL restrictions are essentially the "graduation" of a given product from a given country from GSP benefits.

15 Primarily exceptions include the aforementioned US FTA's, intra-EU trade, and the EU's agreements with the Eastern European countries prior to their accession to the EU.

and Colombia, and ongoing with several member countries of ASEAN. While often similar for many products, the set of rules of origin in each of these agreements is unique. Indeed, only in the cases of Peru and Colombia are the rules of origin identical, and this because they were negotiated together, initially as a single agreement that was later separated into distinct agreements, though always with a view to recombining them. In each of these agreements, as currently drafted, cumulation is limited to the parties to the respective agreement[16].

Japanese GSP

The Japanese program applies rules of origin that are similar in structure to the EU GSP, generally requiring a change of heading, supplemented with a long list of product-specific requirements. The cumulation provisions permit the use of Japanese-originating materials, and identify one five-country grouping of ASEAN members within which cumulation is also permitted. Japan also has a rapidly expanding network of FTAs in Asia and Latin America, heavily focused on ASEAN members, and also with both Mexico and Chile. The style of these rules varies across agreements, generally becoming more complex over time. The ASEAN-Japan Closer Economic Partnership (AJCEP) seeks to consolidate several Japanese FTAs with ASEAN countries, and will permit cumulation among all signatories. Indeed, the consolidation of the cumulation zone within the AJCEP is one of its main selling points.

Canadian and Australian GSP

The GSP programs of Canada and Australia both apply RVC-based rules of origin. The Australian program requires that at least half of the factory or ex works cost of the goods must consist of the value of labor and/or materials of one or more developing countries. In Canada's case the rules limit non-beneficiary originating materials may represent no more than 40% of the value of the good.

The cumulation provisions in these two schemes, however, contain an important difference from the other schemes considered thus far. Both of them allow for cumulation not only of material inputs from the respective grantor country, but also of inputs from any of the other beneficiaries. That is, the beneficiaries are not divided into regional groups within which cumulation of materials is permitted, but rather all materials produced and originating in any of the beneficiaries may be used in any of the other beneficiaries without counting against the

[16] There does exist a provision in the origin chapters of the USA-Peru and USA-Colombia agreements that states that the countries will consult to implement cumulation once the agreements are both in force.

latter's compliance with the origin requirements. Both countries are also negotiating a growing number of bilateral agreements.

Other Countries' GSP

Several other developed countries also maintain GSP programs, such as Norway, Turkey, the Czech Republic and Hungary. Their rules are often similar to the EU rules, as are their cumulation provisions. Some countries that previously maintained independent GSP programs have joined the EU, and thus now form part of that GSP program.

Product Level Rules and Cumulation Provisions in Several GSP Programs

Grantor	Product Level Rules	Cumulation Zone
EU	General change of heading, with many exceptions based on RVC or processing requirements.	Cumulation permitted within three regional groups.
US	"New and different article of commerce" plus a 35% RVC.	Cumulation beyond the beneficiary country and the US is limited to regional integration agreements existing and identified in the trade act of 1974 (6 groupings)
Japan	General change of heading, with many exceptions based on RVC or processing requirements.	Cumulation beyond the beneficiary country and Japan is limited to countries within one 5-country subset of the ASEAN agreement
Australia	50% RVC	All GSP beneficiaries may cumulate
Canada	40% RVC, with different requirements for textiles and apparel	All GSP beneficiaries may cumulate

In sum, the GSP programs of the main developed countries establish rules of origin with dissimilar product level rules and cumulation provisions that limit the use of materials from other beneficiaries. These factors have often been cited as significant obstacles to the programs' success in effectively using the trade preferences for promoting development of the beneficiary countries.

IV. Solutions Proposed in the Past

There are a variety of proposed solutions to the problem of overly-restrictive rules of origin in TPFD programs. The EU has been relatively pro-active in undertaking a public review

of their rules of origin, soliciting comment, and proposing modifications[17]. Most significantly, the current proposed change is to adopt a 30% across-the-board value added rule for simplicity and transparency, replacing the long list of processing requirements and CTC rules[18]. This reform is not as far reaching as the Blair Commission on Africa's suggestion of a 10% value added rule, but is a step in that direction. Cadot and De Melo (2007) have published a detailed analysis of the costs derived from compliance with rules of origin, arguing for harmonization, simplification, and relaxation of the rules of origin in TPFD schemes. All of these proposals focus on the specification of the rules, without addressing the issue of the scope of the cumulation zone[19].

Furthermore, the complaints regarding the impediments posed by rules of origin have focused on the implied lack of market access, implicitly assuming that market access unfettered by RoO would provide the development outcomes that the preferential policy was intended to achieve. This assumption has never been clearly examined.

To do so, it is worth first recalling that products exported by developing countries that have zero or very little imported content, such as most raw materials and agricultural products, will not be in any way impeded by the rules of origin, as such rules function only to place limitations on such foreign content[20]. Goods that are "wholly obtained[21]" in a beneficiary country will always meet any origin criteria. Rules of origin only begin to matter when considering more elaborate products which may combine materials from more than one country. As discussed above, in these cases more demanding rules increase costs for producers, which will depress utilization of preferences. In such elaborate products, as has been pointed out based on a static analysis of costs and availability of originating materials, the value of the preference can be less than the cost of compliance with the rules. Even in a more dynamic analysis, while there is an incentive to invest in productive capacity in the beneficiary country in order to qualify for preferences, the cost of such investment, especially when those preferences are uncertain over time, may exceed the expected value of the preferences.

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17 Implementation of these reforms is scheduled for 2009, but there is some uncertainty as to whether this timeframe will be met.

18 In fact, this would represent a movement in the direction of harmonization of rules with the US, with the difference being 5 percentage points (and the US new article of commerce requirement) as well as differences in product coverage and the details of the calculation method of the value added.

19 Several EU documents do address the issue of cumulation, but the current draft regulations actually complicate the cumulation provisions more than they improve them, by defining new groupings and not specifying the treatment to be given to the old groups. Also, the Blair Report speaks of "global cumulation", but does not specify exactly what this means.

20 This is one explanation of the high share of petroleum products in the usage of US GSP preferences.

21 "Wholly Obtained" refers to good with no third-country content at all. These are generally primary goods cultivated, harvested, or extracted from the earth in the territory of a country.

Now, consider an extreme hypothetical case of a tariff preference with no rule of origin. As mentioned earlier, this leads to trade deflection, which is approximate to a unilateral liberalization *vis a vis* all countries. But what are the implications for development of such a situation? In the absence of any limitation on the degree to which materials may be imported from non-beneficiary countries, there would be an incentive to directly import the finished good from the most efficient (and therefore lowest cost) global producer, and re-export the product to the preference-granting country duty free. This pure trade deflection would not generate any investment in production capacity (i.e. "development") in the beneficiary country, as the necessary capacity would consist of a minimally functional port in which the transit of the good through the territory of the beneficiary country could be documented. Any profit would accrue only to those in a position to take a cut.

Moving away from the extreme case, consider a minimal rule requiring 1% value added in the beneficiary country. The standard method of calculating "value added" is based on the difference between the price received by the final manufacturer and the costs of non-originating materials (imported from countries outside the cumulation zone) and used in the production of the good in question. It is reasonable to assume that the price paid for the imported materials on world markets is unaffected by the beneficiary country's preferential access to the developed country's market[22]. The price received by the final manufacturer, on the other hand, is likely to be affected by the preferential access.

Tariffs on goods serve to raise their domestic price in a protected market above the unprotected "world price". When a producer is given preferential access to a market, the whole point of such access is that she will be able to receive the higher "tariff-protected" price in that market without having to pay the tariff. This means that she can charge a price above the "world price" and still remain competitive in the preferential market. The degree to which the producer's price may exceed the world price is limited by the size of the tariff that is applied to imports from non-beneficiary countries. If that tariff is large, the difference between the producer's price in the grantor's market and production costs of imported materials can increase, even if no value is added through processing in the beneficiary country.

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[22] In economic terms, assuming perfectly competitive world markets for inputs.

Thus, because the producer can sell at a higher price in the preferential market, for purposes of the rule of origin's value added calculation the duty-free access adds value in and of itself. If the minimal 1% rule is in place, simply triangulating finished products through a beneficiary country would result in the rule being met, because once inside the territory of the beneficiary the mere possibility of qualifying for preferential treatment in the grantor's market adds some value, and leads to the good actually qualifying. In effect, the triangulation adds at least 1% value and we're back at the case of there being no real rule at all.

Take a concrete hypothetical example. Imagine a firm in Somalia imports toy cars from China. Once the toys are in Somalia, if the firm wishes to export them to the EU under the GSP, a determination must be made as to whether they meet the rule of origin. Say the Somalis bought the toys from a distributor in Hong Kong for 10 Euros (the world price), and had they been directly exported to the EU they would have paid a tariff of 2 Euros, and thus been available in the EU for 12 Euros. The firm will be able to show that the sales price in the EU would be easily more than 10.1 Euros, and if the rule of origin requires nothing more than 1% value added the requirement would be met despite no processing whatsoever[23].

Consider the potential "development' benefits of this situation. Because merely bringing the materials into a beneficiary country is likely to be sufficient to qualify for preferential treatment in the grantor, there is no incentive to invest in capacity to add meaningful value in the beneficiary country. There is not even a need to employ people to work in assembly. The only people who stand to gain from this arrangement are those who supply the triangulated good, and those in a position to capture rents from the triangulation. In short, there is no development benefit. In order to promote development, some rule beyond the "minimal" rule is necessary.

Extremely lax rules of origin are unlikely to promote development any more than very strict rules of origin.

But how far beyond a "minimal" rule is it optimal to go? For goods that are likely to contain imported materials the extremes are clearly not optimal – the corner solutions (i.e. "wholly obtained" or "no rule") can be ruled out. Highly restrictive rules (those that impose

[23] Most origin regimes, including that of the EU GSP, include lists of "minimal processes" that do not confer origin. (repackaging, dilution of a material in water, etc). Such a provision could be used to avoid this particular case, but if the exclusion of minimal processes is the only processing desired, then that should be the rule, and the value-added requirement could be dispensed with. The list is usually meant to serve as a necessary supplement to other more demanding rules, not to be a sufficient rule in and of itself

large compliance costs on producers) should be avoided, as rules whose compliance costs exceed the value of the tariff preferences serve only to eliminate any potential development benefits[24].

Cadot and De Melo (2007) survey empirical analyses comparing preference utilization rates in several TPFD programs with different measures of rule restrictiveness, and summarize empirical evidence that many TPFD rules of origin are more restrictive than is necessary to prevent trade deflection. Their arguments are valid, and this discussion is not intended to be a defense of the status quo, though there is less evidence that all rules need reforming. Nevertheless, clearly there are cases of rules of origin that do exactly what these authors claim: capture most of the benefits of the preferential liberalization for the input suppliers in the developed countries, and minimize the benefits for producers in the developing countries[25]. They conclude that there is a need for harmonization, simplification, and relaxation of the rules of origin in TPFD programs.

There are good arguments for harmonization and simplification. Producers in developing countries that wish to sell to multiple GSP grantor countries must master the intricacies of each scheme, ascertaining the eligibility of their country and product in each grantor, identifying and understanding the rule in each, adjusting their input mix to comply with those rules, and mastering the documentation requirements of each. All of this in countries with recognized limitations in "trade capacity" to begin with.

But it is not entirely clear that very lax rules are a useful solution. The "1% rule" discussed above is purely for illustrative purposes, but even the across the board 30% value added rule that the EU plans to implement in the near future could have unintended consequences. While there is no broad survey available, there is anecdotal evidence that relaxing the GSP rules will undermine some intermediate producers in developing countries rather than help them.

Consider one example. As it happens, the economics of producing knit fabrics is quite different from that of producing woven fabrics, with knit fabric production being more easily scalable. The EU's GSP rules for apparel have historically required that all fabric be originating and this has led to substantial investment in Bangladesh in the capacity to produce knit fabric.

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[24] There exists some debate as to the best criteria types (e.g. CTC vs. RVC) for defining rules of origin (e.g. Inama (2006). This is not the topic addressed here.

[25] Rules for textiles and apparel are often cited as the most egregious.

As the rules are reformed, there is concern that even more inexpensive knit fabrics from outside Bangladesh will be substituted for domestic fabrics, undermining these investments[26]. The 10% value added rule proposed by the Blair Commission for Africa and subsequently repeated by others would reduce the demand for intermediates produced in developing countries by even more.

The tension between market access and development goals in setting rules of origin is not a new problem. A European Commission document[27] expresses it well enough to merit quoting at length:

> "… certain [..] countries no longer [want] just to export cotton fibres with a low value added, but [want] to start selling fabrics and clothes. This approach would tend to favour an industrial view of development, with rules of origin requiring a high level of vertical integration. At the same time, certain [other] countries, specializing in labour-intensive industries, would like to be able to buy in semi-finished products so that they can make full use of the advantage that a generally lower level of wages gives them on international markets. Here, a trade-based approach to development, i.e. one that facilitates trade, would be more appropriate. For that, the rules of origin need to be less strict."

The document goes on to recommend that rules of origin should be reformed "in a balanced way that takes into account these different situations". But the situations are not simply different, they are diametrically opposed. These two approaches to development require very different origin policies, and any attempt at "balance" in the definition of the rules risks undermining both. A "medium-restrictive" rule would likely be both too permissive to encourage investment in productive capacity of inputs, and too strict to make efficient global sourcing possible.

It is worth emphasizing again that the discussion here addresses how to optimize the development benefits of TPFD programs. Clearly the relaxation of rules of origin in any preferential program will liberalize trade broadly speaking, with the identifiable benefits that one generally attributes to such endeavors. But the objective of these programs, especially but not

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[26] Bangladesh Apparels Exporter's Bulletin, "Bangladesh Textile sector fears new EU rules" Feb 2, 2008. On purely economic efficiency grounds this is not a problem. Nonetheless the development implications are contrary to the stated aims of the policy.

[27] COM(2004) 461 Final, July 7, 2004. p.4.

exclusively the GSP, is the promotion of development in the beneficiary countries. The GATT/WTO explicitly authorizes deviation from the MFN principle for the purpose of promoting development. The question is how to structure the rules of origin so as to maximize the potential effect.

How, then, to improve the rules when the empirical evidence needed to best calibrate their restrictiveness is often lacking or inconclusive, and there is reason to believe that the seemingly obvious solution may in fact undermine the development goals that motivate these programs in the first place?

V. A Better Solution

We propose modifications to ease the burden of TPFD rules of origin based on changes to the cumulation provisions. Because political constraints are likely to make drastic changes difficult, we describe and discuss these modifications first in the limited context of the GSP programs, and subsequently in all TPFD schemes.

a. Extended Cumulation in Unilateral TPFD Programs

How can the "balance" between the market access and industrial approaches to development be found? We suggest that the answer lies in the cumulation provisions of the TFPD programs. The developed, grantor countries must allow cumulation of all goods that would otherwise enter the grantor country duty free. In its simplest version, this implies permitting producers in any GSP beneficiary country to count materials originating in any other beneficiary country as if they originated in the final producer's country. We shall call this "extended cumulation".

Allow extended cumulation: all materials originating in any GSP Beneficiary should be cumulable in any other GSP Beneficiary.

This may seem minor, but it is dramatic. Of the GSP programs described above in Section III, only Canada's and Australia's are structured in this way. The others make provisions for extended cumulation within existing (or otherwise limited) regional groupings, but stop there. The current draft regulations of the EU GSP due to be put into force in 2009 change the current configuration of cumulation, replacing the three "cumulation groups" with a system of cumulation within regional integration arrangements. The draft includes a footnote that calls for

"further consideration" of how to maintain the advantages that exist under the current configuration of the cumulation zones.

The currently proposed reforms to the EU GSP programs begin to address this issue when referring to "simplification and relaxation of conditions for cumulation[28]". But the concept remains limited to "countries belonging to economically-integrated regional entities". While countries belonging to existing economically-integrated regional entities are likely to be the first place a producer would look for inputs, there is no obvious trade- or development-related reason that the GSP grantor countries should give explicit preference to such regional blocs[29]. Furthermore, to the degree that promotion of such trade blocs is desirable, whether for geopolitical or other such motivations, there is no reason to promote such blocs as closed fortresses. The objective should always be, and ostensibly always is, to promote "open regionalism" wherein deepening regional integration is accompanied by progressive liberalization *vis a vis* extra-regional countries, not the creation of new barriers.

There is empirical evidence for the effects of extending cumulation in work by Augier and others (2005). The implementation of the PECS in 1997 serves as a perfect natural experiment, as all of the countries had trade agreements in place, and the only change was the extension of cumulation. The authors found that not only did exports of the Eastern European countries to the EU increase as a result of the new cumulation possibilities, but so did trade among these countries, and by proportionately more.

There are two potential levels at which the above recommendation might be implemented: 1) cumulation in GSP beneficiaries of materials originating in any other GSP beneficiary; and 2) cumulation in GSP beneficiary countries of materials originating in any country where such materials would enjoy duty-free access to the grantor market, i.e., in any TPFD beneficiaries or FTA partners of the grantor. In the first case, the cumulation zone for the GSP preference program would be limited to the full set of beneficiaries, plus the grantor (all GSP programs already provide for cumulation of materials originating in the grantor). In the second case, the set of beneficiaries remains the same, but the cumulation zone is extended to include all countries whose exports of the materials to be cumulated would enter the grantor duty free if exported directly.

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28 COM(2005) 100 Final. March 16, 2005.

29 Indeed this is an unrecognized violation of the MFN spirit, even under the anti-MFN Enabling Clause.

A recent report by the US Government Accountability Office (GAO) on US trade preference programs[30] provides an anecdote of precisely this situation. A firm in Ghana was importing white T-shirts from Honduras and printing African designs on them, and then exporting the printed T-shirts to the US. These shirts, it turned out, were not eligible for preferences under the AGOA because the T-shirts were not originating under AGOA, despite the fact that they most likely were originating under the DR-CAFTA and would have entered the US duty-free had they been exported directly to the US from Honduras.

This situation is troubling in several ways. First, the fact that the Ghanaian producers chose Honduran T-shirts in the first place indicates that these were probably the most cost-competitive available (and possibly even produced in a US-owned plant in Honduras). The AGOA origin rules, by not allowing the use of Honduran shirts, will thus most likely lead the Ghanaian producers to use shirts of lower quality or higher cost, at no benefit to the US consumer. Indeed, the GAO report indicates that the producer intended to seek out suppliers in South Africa. This undermines the benefits of two US TPFD programs at the same time: the AGOA by raising the production costs in Ghana, and the DR-CAFTA by limiting the export opportunities of the Honduran manufacturer. And every single material input, had it been exported directly to the US, would have entered duty-free.

The "balance" between rules that promote investment in value-adding capacity ("industrial development") and employment-generating assembly ("trade based development") that was sought in the EU communication cited above, can thus be found in sacrificing "strictness" in the rules applied to any given beneficiary country in favor of "strictness" applied to all beneficiaries taken together. In the Ghana-Honduras case, there is no need to change the rules for printed T-shirts under AGOA. Instead, provision only need be made for cumulation across TPFD programs. This would promote both kinds of development, though spread across beneficiary countries as they choose, and as their markets make possible, and not at the predetermined discretion of the grantor countries.

Compare this extended cumulation approach to the effects of reforms that simply reduce the observed restrictiveness of the rules. In the latter case, greater use of materials imported from third-countries is permitted. When the effective restrictiveness of the rules of origin is reduced through extended cumulation, this is also true, but the grantors can control which third countries

[30] GAO (2008) p.77

may participate. In the case of expanding cumulation to materials originating in any other TPFD beneficiary or FTA partner, the set of third countries in the cumulation zone is limited to those that have either been previously identified as eligible for unilateral preferences based on their level of development, or have completed negotiations of a reciprocal trade agreement with the grantor.

There are a handful of examples of this approach being taken. Norway and Switzerland, members of EFTA, petitioned the EU to allow beneficiaries of the EU GSP to cumulate materials originating in either of these two countries for purposes of that program. The FTA between Canada and Israel permits cumulation from the US. The EU-South Africa EPA permits cumulation from other ACP countries, and the DR-CAFTA agreement between US, Central America, and the Dominican Republic includes provision for a very limited extended cumulation of fabrics from Canada and Mexico in the production of some apparel products. These examples are all quite limited in scope, but are a clear illustration of two points. First, that the limitations posed by the rules of origin create difficulties for the beneficiaries that the grantors are willing to address; and second that suppliers of materials from outside the immediate beneficiaries have an interest in securing better access through final goods producers in those beneficiaries.

Extended cumulation is not an entirely new idea, but has never been clearly articulated in the TPFD context. Where the Blair Report speaks of "global cumulation" as inspired in the AGOA context, this is actually a misnomer, as what it really entails is less restrictive tariff-shift rules that allow use of third-country fabrics. But the concept is there. What the AGOA provided for apparel was a set of rules that permitted certain LDCs[31] in Africa to source most fabrics from anywhere in the world and still maintain originating status. While not cumulation in the proper sense of the word (these materials are not considered as originating, they simply do not disqualify the product from access to preferences), this provision allows apparel manufacturers to source fabrics from the global least-cost supplier (generally China). This cost advantage, along with the tariff preferences, makes the final clothing more competitive in the US market, which creates an incentive to invest in assembly capacity in these LDCs. The relaxation of the rules in this case also benefits countries that are not generally eligible for preferential treatment, such as China, as they can sell fabric to AGOA LDCs and have them incorporated into apparel for the US market

[31] 17 of the 42 AGOA beneficiaries.

One question that arises when considering the implementation of extended cumulation is: Which rule of origin should the materials to be cumulated, and final products containing them, meet? The limited endeavors of this type have tended to have a harmonization of the specific rules across all included bilateral relationships as a prerequisite. Examples of this include the PECS and the Paneuro-Mediterranean free trade area. The countries in these systems become eligible to participate in the extended cumulation area only once they have in place agreements among them that specify exactly the same rules of origin. If one were try to scale up this approach to encompass all TPFD beneficiaries, the negotiations on the harmonized rules would rapidly become unmanageable.

Instead, what we propose is that, by concentrating on the logic that materials that would have otherwise entered the grantor market duty-free should be cumulable, the materials should meet the rules applicable between the grantor and the country in which the materials are produced, and that the final goods should meet the rules applicable in the TPFD program under which they are exported to the grantor.

In the case of the Honduran T-shirts printed in Ghana, the shirts should meet the DR-CAFTA rule for the shirts in order to be cumulable, and when exported from Ghana the printed T-shirts should meet the AGOA rule of origin for printed shirts, by counting the T-shirts as originating. This rule maintains the requirements agreed to with the FTA partners in their negotiations, while still making the rules less burdensome for the unilateral program beneficiaries.

Note that extended cumulation in this proposal would give renewed importance to the certificate of origin. In the specific example, Ghana gives no preferential treatment to Honduras, and so there would be no reason for the Honduran T-shirt producer to issue an origin certificate for that transaction. However, when the time comes for the Ghanaian firm to export the printed T-shirts to the US, they will need to be able to demonstrate that the shirts are originating under the CAFTA rules and thus cumulable. The best way to demonstrate that is with a certificate of origin from the producer of the shirts. Note also that the certificate make the shirts more valuable, as it gives a measure of certainty to the Ghanaian firm that the printed shirts will be eligible for the preferences. This added value may translate into a higher price for the Honduran producer as well.

An alternative way of looking at this proposal is to consider the absence of such extended cumulation and ask "Why not?" What countries should be excluded from the cumulation zone for GSP beneficiaries? In the case of the US, why should one beneficiary be prevented from using materials originating from any other beneficiary? To do so limits the value of the preferences for both. The producer of the final good is precluded from using one possible source of material inputs, and the producer of those inputs loses a potential customer. As a specific example, why should Paraguay, a GSP beneficiary, be forbidden to cumulate material inputs originating in Uruguay when these materials would enter the US duty-free if exported directly from Uruguay under the GSP?

There is no obvious answer to this question[32]. The most likely explanation is simply that the rules were defined in an era before supply chains became globalized, and there was no reason to worry about the limitations implied by strictly bilateral cumulation. Times have since changed.

Granted, relaxing origin requirements through extended cumulation provisions, much like relaxing the rule requirements as discussed in hypothetical cases above, will reduce the incentive to invest in value-adding capacity in any one beneficiary country. Once a producer of intermediate goods in one beneficiary can provide materials to producers in all beneficiaries, there is less incentive to invest in such capacity in every beneficiary, as there are likely to be some economies of scale to be gained by centralizing production of those materials in fewer locations. But there is no ex-ante reason to prefer one beneficiary country over another[33].

Furthermore, the lack of potential for taking advantage of such scale economies is likely suppressing such investment today. It has been noted (see Ahmad (2007) that there is no evidence, at least in textiles and apparel, that stricter rules have led to vertical integration of production. While this is not universally true (see the case of knit fabric production in Bangladesh above) it is a fair generalization. But the reason for this outcome is not rooted in the rules themselves, but in the economics of the investments necessary to develop such vertical capacity. It is unlikely to be a profitable investment to install a fabric weaving facility in a small country with a finite apparel assembly capacity if the surplus output of such a facility will be unusable even in neighboring beneficiary country due to the lack of cumulability (to say nothing

[32] Under the Cadot and de Melo (2008) framework, the "North" country uses rules of origin to protect North's capital-intensive materials producers. The restrictiveness due to the limited cumulation does not make sense in this context, as other South countries from which materials could be imported under extended cumulation, are capital scarce.

[33] Indeed this was the substance of the WTO violation that undermined the Cotonou preferences.

of GSP limitations unrelated to rules of origin). The extension of the cumulation provisions to include all beneficiaries could unleash this potential investment.

The goal here is to promote development in developing countries (as identified with objective criteria in the eligibility requirements of the GSP programs). Efforts to target specific sets of countries using TPFD programs are what undermined the Cotonou preferences. "Aid for Trade" programs that target capacity constraints or otherwise promote trade facilitation are a better mechanism for such political targeting for preferred beneficiaries.

At a minimum the cumulation expansion discussed above should be applied in the GSP programs of developed countries, and cover all beneficiary countries of those programs. This sort of reform should also be included as an amendment to the enabling clause that established the framework for the GSP programs, mandating such extended cumulation provisions in all GSP programs. This would be a good fit in the Doha Development Agenda (DDA).

Extended cumulation as regards GSP Programs should be written into the enabling clause in the Doha round.

b. Extended cumulation in all TPFD Agreements

As reciprocal free trade agreements spread, the GSP programs per se, as well as other explicit TPFD arrangements, are declining in relative importance. While these new agreements generally provide superior market access, as well as the certainty of concessions agreed in treaty agreements as opposed to unilateral, revocable legislation, these agreements also function to institutionalize a fragmentation of cumulation zones.

But North-South reciprocal trade agreements have been rapidly proliferating, and these generally replace access to the GSP programs, as well as other unilateral preference programs. This has important effects on both those who sign these FTA's and those who do not. For example, Peru and Colombia could cumulate between them when producing for export to the US under the ATPDEA arrangement, but the ratification of the US-Peru FTA removes Peru from that program, as well as from the GSP, and cumulation becomes limited to the bilateral (US-Peru) relationship. In other words, supplier relationships that span the Colombia-Peru border will be interrupted by the new agreement.

In general, this situation generates two separate interruptions of the extended cumulation reforms proposed above. First, GSP beneficiaries exit the program and lose access to the cumulation from other GSP beneficiaries that do not sign on to the same FTAs. Second, remaining GSP beneficiaries lose access to cumulable inputs produced by the beneficiaries exiting the program. Both of these interruptions can increase the effective restrictiveness of all rules. This particular problem would become even more significant if the GSP programs were modified to permit cumulation of materials from all other GSP beneficiaries.

This same issue affects the Central American countries that have signed on to CAFTA. All were previously beneficiaries of the GSP and the CBI/CBERA. As such, by entering into the CAFTA their producers are no longer able to cumulate materials from remaining CBI countries[34]. While there is not evidence yet of specific harm from this fragmentation of the previous cumulation zone, there is no way to know what opportunities may be lost going forward.

The same phenomenon is witnessed in EU's EPA negotiations with countries in Africa. Current drafts establish agreements with (at least) three subregions, with no provision for cumulation across groupings. Under the Cotonou scheme cumulation was allowed, but new reciprocal agreements will fragment the region and interrupt long-standing supply chains.

It would thus be desirable to include FTAs with developing countries in the process of extended cumulation. Like the modifications to the GSP that would provide for cumulation of inputs from any beneficiary, here we suggest that FTAs with developing countries be amended to permit cumulation of inputs originating in GSP or other TPFD beneficiaries. Like the GSP-centered reforms discussed above, there are two levels to this concept.

First, producers located in FTA partners of GSP grantor countries should be allowed to cumulate qualifying materials from GSP beneficiaries. This would resolve problems like those of Colombia and Peru, and the CAFTA countries and the CBI. Second, because FTA partners of GSP grantor countries are so frequently developing countries, cumulation of originating materials from partners in one such FTA should be made cumulable in all other such FTAs. In this case, Mexico, Chile, Peru and Central America would all be able to cumulate among them and with the members of the US FTA partners in the Middle East as well.

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[34] The remaining CBERA beneficiaries may continue to cumulate from "former beneficiaries" that have entered into free trade agreements with the US (see General Note 17(e)(ii) of the HTSUS). There is not, however, as similar provision in the ATPDEA to address the entry into force of the US-Peru agreement.

Such an approach has political advantages in times of limited public appetite for liberalization. These modifications mostly imply only a change in the implementing legislation of existing FTAs. None of it implies a "new trade agreement" or "another trade agreement". It can be presented instead as a "technical rationalization" of existing preferences, and as a market-based development assistance program.

When applying extended cumulation to countries that form part of a dense network of overlapping FTAs, there will be difficulties of differing rules of origin. As discussed above, in order to be cumulable in another beneficiary, the materials must be produced in a way that meets the rules of origin of the agreement or program that governs the relationship between their country of production and the grantor, and should be accompanied by a certificate of origin compliant with that arrangement. Within this context, there should be no problem of differences in the rules of origin across beneficiary countries.

In principle these modifications to reciprocal FTAs could be applied unilaterally by the developed partner through changes in the implementing legislation in that country. The agreements establish the obligations of the partners to provide a minimum level of market access through tariff elimination and rules of origin, but do not (again, in principle) prevent a party to the agreement from providing even greater market access through these sorts of changes. At the very least such a modification would not violate the spirit of the agreement. Developing FTA partners would still be free to determine their own tariff policies, and so could protect themselves from cumulable materials should they wish to do so.

As an illustration, drawing on an example in Cornejo and Harris (2007) if a developing member of FTA with the US, for example Guatemala, wishes to prevent local coffee producers from having to compete with producers in other developing countries, there would be nothing to prevent Guatemala from maintaining tariffs on those goods[35]. It would be up to Guatemala to determine that policy, not the US.

Overall, it is hard to see how such changes could disadvantage the developing FTA partners. The effect would be to reduce the compliance costs of the rules of origin for their exporters, improving their access to the developed country markets; and it would do so in a way

[35] Except perhaps the Central American common external tariff.

that can be managed through tariffs on imports of newly cumulable materials should the need arise.

There are problems of non-reciprocity to contend with, however. Producers in the GSP grantor countries would be justified in complaints that these changes benefit the developing FTA partners while not extending to domestic producers the same facilities when exporting under the same agreements. Optimally, then, the cumulation expansion in both cases would be a bilateral undertaking (see Cornejo and Harris (2007) for an expanded analysis of the mechanics of this type of "full convergence" process), where both the GSP grantor and the developing country FTA partner would negotiate the reciprocal application of extended cumulation with LDC countries.

This is yet a third potential level to this reform, where the FTA partners permit producers in the GSP grantor countries to cumulate materials from LDCs. This is much more complicated than the cases above, as the FTA partners generally are unlikely to have established direct preferences for the LDCs that could be extended through cumulation to producers in the GSP grantor. As such, the magnitude of negotiations that would be required to implement such an expansion of cumulation would probably be prohibitive. Still, the US and Australia, which are both GSP grantors and have a functioning FTA between them, could conceivably implement such a reciprocal recognition of extended cumulation to GSP beneficiaries, much as Norway, Switzerland, and the EU have done.

As an aside, it is worth noting that the logic of extended cumulation could be applied as a path towards "convergence" of overlapping FTAs, quite independent of the development promotion aspects of such endeavors. In regions where there are already many FTAs, but in which for whatever political complications a full convergence of these agreements is not feasible, the implementation of extended cumulation could be seen as a first step in that direction within the context of the existing FTAs. For example, in the APEC region the US has agreements ratified and/or in force with Singapore, Chile, Mexico, Peru, Canada, and Australia, but currently makes no provision for cumulation across them. If the US were to implement extended cumulation, materials originating in any of those three partners under their respective origin regime could be cumulated in production in any other for preferential export to the US.

In fact, the recently signed FTA between Canada and Peru[36] makes explicit provision for moving towards extended cumulation. Paragraph 3 of Article 306 stipulates that "…where each Party has a trade agreement […] with the same non-Party, the territory of the non-Party shall be deemed to form part of the territory of the free trade area established by this Agreement, for purposes of determining whether a good is originating under this agreement." The reciprocity issues mentioned above show up in the following paragraph with the stipulation that "A Party shall give effect to paragraph 3 only once provisions with effect equivalent to paragraph 3 are in force between each Party and the non-Party." In other words, Canada and Peru will only let others participate in the expanded cumulation zone once those others return the favor. The paragraphs also leave unspecified which rules would apply to materials and final goods, and under what circumstances, presumably to leave space to negotiate with the as-yet undefined non-Parties. Still, Canada and Peru have common FTA partners in the US, Mexico, Chile, and probably in the near future, Colombia and Singapore as well. Once these dominos start falling, this could be the core of a significant cumulation zone.

[36] http://www.international.gc.ca/assets/trade-agreements-accords-commerciaux/pdfs/Canada-PeruFTA_chapter3-en.pdf

Summary of Proposed Changes

In the end, the different options boil down to different determinations of which countries are excluded from the cumulation zone in the TPFD programs, broken down here into 5 levels.

Table: Summary of 5 Potential Levels of Expansion of Cumulation in TPFD Programs

	Level	Materials Produced → Materials Cumulated → Final Country of Import	Program that must be modified
Changes to Unilateral Programs	**1**	GSP Benef. → GSP Benef. → GSP Grantor	GSP
	2	Any TPFD Benef. or FTA partner → Any TPFD/GSP Benef. → GSP Grantor	GSP/TPFD
Changes to Reciprocal Agreements	**3**	GSP Benef. → FTA partner → GSP Grantor	FTA administration procedures in developed
	4	FTA partner → FTA partner → GSP Grantor	FTA administration procedures in developed
	5	Any TPFD Benef. or FTA partner → GSP Grantor → FTA partner	FTA administration procedures in all member countries / Renegotiation

Levels 1 and 2 concentrate on expanding cumulation within existing unilateral TPFD programs. The unilateral nature of the programs would make these the simplest to implement, and as they are subject to the Enabling Clause of the GATT/WTO it would be helpful to amend the clause to include a requirement of such extended cumulation. Indeed, if all grantors were to adopt the Canadian and Australian approach to cumulation within their GSP programs, then all goods produced exclusively from materials originating in GSP beneficiaries would meet the rules of all GSP programs[37], regardless of the actual rules specified, because all of the materials would be cumulable.

Levels 3 and 4 include modifications to reciprocal TPFD programs (FTAs with developing countries) to allow cumulation of materials originating in beneficiaries of unilateral programs (level 3) and in other reciprocal programs (level 4). These two options only include

[37] This assumes that the GSP programs identify exactly the same beneficiaries, which they do not, but the differences are not large, so the exceptions to this generalization would be few in number.

recognition of this cumulation on the part of the developed country members. This would have the effect of reducing the effective restrictiveness of the rules for producers located in the developing country members of the reciprocal agreements, as well as creating new markets for intermediate materials produced in the beneficiaries of the unilateral programs. The developing country members are left to regulate the openness of their markets to materials from the unilateral program beneficiaries as they see fit, but once such materials are imported by them, they are cumulable for purposes of export to the developed members. The primary problem with these situations is the lack of reciprocity for producers located in the developed country members.

Level 5 includes the maximum expression of extended cumulation in TPFD programs, broadly defined. This involves negotiating with developing members of reciprocal TFPD programs to permit production in the developed members to cumulate goods originating in unilateral TPFD programs. This is also likely to be the most difficult to implement, and it is not clear ex ante if the benefits would be sufficient to outweigh the negotiating costs.

The only significant argument against extended cumulation would lie in the difficulties of administration and verification of origin to which such reforms could lead. We address this issue in the next section.

VI. Administrative Difficulties

The primary disadvantage of permitting cumulation of any material that would otherwise enter a TPFD grantor country duty-free is the increased administrative burden of demonstrating, proving, and verifying origin claims. The reality of the unbundling of production processes across multiple countries indicates that it is reasonable to expect extended cumulation provisions to bring investment in productive capacity to multiple beneficiary countries. But the documentation requirements are likely to be concomitantly burdensome.

In existing programs, grantor countries generally can initiate origin investigations and carry out audits to verify origin claims up to 5 years after the goods were imported. This means that importers, and to varying degrees exporters, producers, and all of their suppliers, must maintain detailed records of the origin and value of materials used all along the production process of the final good, to say nothing of having modern, efficient, reliable inventory control systems in place that would have generated such records. Failure to maintain records can lead to ex post denial of preferences and even to penalties. These challenges present difficulties under existing agreement structures, and expanding the cumulation possibilities could only exacerbate such difficulties.

But the fact that the paperwork might be difficult should not prevent adoption of these sorts of policies. To the contrary, these challenges should be seen as an opportunity for increased trade facilitation efforts. While documentation of origin adds a layer of administrative burden to transactions that seek to take advantage of tariff preferences (be they GSP, FTA, or other preferences), thus far there has been little or no coordinated effort to significantly streamline these procedures.

The WCO or the WTO could serve as forums for definition of best practices. The developed grantor countries could and should design institutions or systems for the tracking of supply chains that both aid producers in the beneficiary countries to demonstrate origin and aid the grantor countries themselves in any verification process. Such systems could also serve double-duty as supply chain security mechanisms. Furthermore, if such systems were harmonized by the grantor countries, or at least well coordinated, there would be additional benefits for producers in the developing countries that benefit from multiple GSP programs.

Aid for Trade efforts could be focused on mechanisms for record keeping and electronic certification of origin. Such digital solutions could facilitate the transmittal of information

regarding the cumulability of materials so that products incorporating them may then qualify for preferential treatment. Indeed, the inclusion of such documentation with the materials would increase their value, adding to export earnings of their producers.

At the risk of offering too detailed a proposal, we sketch out one idea. The GSP grantors could cooperate to create an internet-based registry of origin certificates. The system would link certificates to specific shipments and to specific producers (via invoice numbers and dates), providing traceability of materials. Materials with origin certificates would be more valuable (because this would make them cumulable), so there is an incentive for producers to use the system. Traceability subsequently aids in verification, especially in combination with risk analysis procedures and the use of pre-authorized exporters. This would allow customs to expedite clearance of goods certified under this system, creating further incentives for their use. Even if the various GSP grantors (US-EU-Japan-Canada-Australia-EFTA) do not "harmonize" information requirements and/or origin-related procedures, it would still be possible to "unify" the certificate registry procedures, providing a TPFD "single window" for origin information. A centralized listing of valid, verifiable origin certificates would facilitate arm's-length transactions for materials producers in GSP beneficiary countries, boosting their potential to export.

This is just a rough sketch of how a unified approach, even if not harmonized, might reduce the burdens of origin compliance for TPFD beneficiaries. The US Customs-Trade Partnership Against Terrorism (C-TPAT) is already creating mechanisms for registration of traders in ways similar to what the EU "Authorized Exporter" programs are doing, albeit for different purposes. A centralized registry like the one sketched out above could even be of use for more than just TPFD origin purposes. But regardless of how, or if, the GSP grantors coordinate origin-related trade facilitation, this potential burden should be viewed as an opportunity to better integrate the developing countries into the international trading system, and not as an obstacle to providing better market access to LDCs.

VII. Longer-term Implications for the International Trading System

Thus far we have set out the logic for how extended cumulation can help TPFD programs promote development. But there is another potential benefit of such reforms.

An intriguing possible effect of these changes to the TPFD origin regimes is the expected effect on the trade-policy calculus within developing countries. In the context of Baldwin's (2006) framework, improvements in market access lead to structural changes in the participating

economies that, in turn, lead to greater interest in even greater market access, and to a willingness to exchange liberalization for liberalization. Thus, the realignment of incentives that would be expected from extended cumulation in TPFD programs would lead to greater liberalization among developing countries.

Furthermore, most of the benefits of MFN tariff reductions are not expected to accrue to developed countries. A World Bank CGE study that was published shortly after the launch of the Doha Round showed that most benefits of global free trade would come from South-South liberalization, benefiting the developing countries. However, the current GSP cumulation provisions are in fact an impediment to South-South liberalization. The expansion of cumulation as laid out above would remove this impediment. If channeled properly in WTO negotiations, this would also lead to better prospects for progress in multilateral tariff reductions[38].

The basic logic is quite simple. In their current configuration of bilateral or otherwise limited cumulation, TPFD programs generate no incentive whatsoever for beneficiary countries to open their economies to imports through tariff reductions. In the internal political dynamic within each developing country, exporters see no point in lobbying their own governments to liberalize for two reasons. First, the Enabling Clause rules on the GSP explicitly frees the beneficiary countries from having to give any sort of reciprocity for the preferences, on an MFN basis or otherwise, and so exporters need not press for liberalization in order to secure access to developed markets. In other words, exporters in the beneficiary countries do not need their governments to pay for access with access – they get it for free.

Second, exporters interested in taking advantage of GSP preferences are discouraged from importing material inputs, even from other beneficiaries, as these would count against them in evaluating compliance with the rules of origin. It is thus a matter of relative indifference to them whether there are tariffs in place on these materials or not. There is nothing to be gained by lobbying for domestic tariff reduction, because imported materials are of relatively less value to exporters as they are not cumulable. Thus beneficiary governments hear only from import-competing industries that have an interest in maintaining tariffs, and proceed to defend those industries in multilateral negotiations.

[38] Not that developing-country resistance to NAMA liberalization is the only impediment to a successful conclusion of the Doha Round, but it is one twig in the current logjam.

Extending cumulation in the TPFD programs would eliminate the second of these reasons. The imbalance in favor of continued protection would be tilted less strongly against liberalization and fuller engagement in the multilateral system. The "free" preferences would continue under the rules of the Enabling Clause, but the exporter interests would be reengaged by the possibility of cumulation. Because inputs from other beneficiaries would be cumulable, there would be an incentive to press for liberalization of imports from those other beneficiaries.

And this incentive would work in both directions. Not only would exporters of final goods be interested in access to inputs without paying tariffs in their own countries, but exporters of intermediates would be interested in lobbying other beneficiary countries to lower barriers to their products in order to sell to producers of final goods. In short, there would be more of an interest in broader, multilateral negotiations.

Extended cumulation is not just a strategic "trick" that developed countries could play to lure GSP beneficiaries further into the international system contrary to their interests. Quite the opposite, such a system would promote the sort of investment in productive capacity in beneficiary countries that would make their engagement in the multilateral system very much in their interest. If such modifications to the TPFD schemes succeed in fostering investment in export capacity, the gains to liberalization increase for beneficiary countries.

As production processes become more and more globalized, any individual country will take a smaller part in the production of each good. This "unbundling" or "fragmentation" of production allows for greater specialization and efficiency, but is dependent on lower barriers to trade between countries. This trend also allows smaller and less developed countries to participate in production, where their comparative advantages can be brought to bear on small elements of the production process. One of the barriers that prevent GSP beneficiaries taking greater advantage of the fragmentation of production is the limits on cumulation within those programs.

There exists empirical evidence for this logic of the relationship between the GSP programs and liberalization by developing countries. Ozden and Reinhardt (2005) find empirically that the GSP has hampered trade policy liberalization in developing countries in general, which includes South-South liberalization in particular. Their proposed mechanism by which this effect has occurred focuses on the political economy of liberalization discussed above, whereby the GSP, in the context of the non-reciprocal access provided under the enabling clause,

has provided exporters in these countries with relatively secure access to the developed-country markets, without the need for these exporters to lobby their governments to provide liberalization in return (that is, there is no requirement for reciprocity) [39]. Because the developing country need not grant market access in return for the preferences that the exporters seek, there is no need for the exporters to press for such liberalization. The limitations on cumulation in the GSP programs also fit in this logic. Because the rules of origin penalize the use of materials from most other beneficiaries, there is even less need for liberalization. Even the cumulation that is permitted within existing integration schemes is not a boost to broader liberalization, as the identification of these groups has not changed for 30 years.

The changes in the cumulation provisions of the GSP programs proposed in Section V above would change this dynamic, at least within and among the beneficiary countries. Removal of this restriction would immediately create an incentive for these producers to seek lower barriers to these imports. Once exporters can make use of more imported imports without losing access to GSP preferences, the tariffs on these inputs will enter into their cost calculations, and will provide the impetus to seek tariff reductions. The provisions in existing GSP programs that provide for cumulation from other countries in existing regional groupings has not served this purpose because it only applies to inputs whose tariffs have already been eliminated under those regional agreements.

The existing cumulation provisions of the various TFPD programs have done little or nothing to create conditions that would lead to political-economy incentives to liberalize. Because in most cases inputs brought in from other developing countries cannot be used in the production of goods for export under GSP provisions without jeopardizing their originating status, there is little demand for such imports, and no lobby for reductions in the tariffs charged on them. Absent such political pressure for liberalization, any protectionist interest will be unopposed and tariffs will remain high.

At the same time, any production of inputs within beneficiary countries will face a market limited to the magnitude of domestic production capacity of the goods that use those inputs. Because final goods producers in other beneficiary countries cannot use such inputs without jeopardizing market access under GSP, there is an impediment to the development of export markets, and no incentive for input producers to seek tariff reductions in other countries.

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[39] Baldwin (2006) discusses this as an older observation.

In short, the limitations on cumulation in TPFD programs serve as a barrier to South-South liberalization[40]. Reduction or elimination of this barrier would generate meaningful incentives for such liberalization. "Open regionalism" should be promoted by preference programs, not discouraged. TPFD programs should not encourage regional integration schemes that are closed off from the rest of the trading system. This is not in the interest of the beneficiaries or the grantors.

Extended cumulation in TPFD programs is certainly not an instant panacea for stalled multilateral negotiations. Expanding cumulation to all GSP beneficiaries might, in some cases, lead to new bilateral or regional agreements as specific cross-border producer-supplier relationships create conditions that make them politically feasible. The more general expectation, at least initially, would be for individual firms or industries in each beneficiary to seek reductions in the applied tariffs on particular inputs. Because at any given point exporters' lobbying interests are likely to focus on the tariffs on a specific material input, the changes will likely be in the MFN applied tariff on that input as this is less costly than negotiating a more comprehensive agreement with the particular country of interest based on one industry's or firm's need for tariff reductions on a limited set of materials. Thus we would expect to see applied tariffs being lowered, increasing the amount of "water"[41] in the tariff structure of these countries. The water then constitutes negotiating space in subsequent multilateral negotiating rounds. All of this will take time.

On the expanding regionalism front, allowing cumulation under GSP of inputs that would receive duty-free treatment under a reciprocal FTA would not undermine incentives for subsequent FTAs with the grantors. Because of the growing relative importance of services and intellectual property in the developed economies, the fact that regulation of these topics can be included in FTAs is an incentive to trade market access in goods for such regulation. But GSP

[40] It is hard to judge this barrier's importance relative to other barriers, but it is a disincentive nonetheless.

[41] "Water" is a term for the difference between the tariffs that are actually applied by a country on an MFN basis and the tariff limits agreed to by that country in the WTO (the "bound rates"). Where this difference is large (i.e. where there is a lot of water), the country could agree to a significant tariff "reduction" in the WTO and still not have to change the applied rate.

would remain a unilateral concession from which beneficiaries could be graduated or otherwise made ineligible (Competitive Need Limits, etc.), or the program could simply not be renewed. Besides, incentives for developing countries to join FTAs with developed countries may be more related to other disciplines (investment, for example) and to the provision of policy anchors[42], than just market access in goods.

VII. Conclusions

We have argued that expansion of the GSP cumulation provisions should be seen as an important component of any reform of the rules of origin, indeed the most important component, and that to best promote development through the GSP and other TPFD programs it is key that the cumulation provisions be integrated across them, to the point that any material that would enter the grantor duty free should be cumulable in any beneficiary. Merely relaxing the requirements of the rules may in fact be counter-productive from a development promotion perspective. The burden of administrating the cumulation of materials across more countries should be seen as an opportunity and not an obstacle.

The rules of origin are not, of course, the only element of the GSP programs that should be addressed. The product coverage in many cases, especially the US, is limited and could be expanded. The "competitive needs limits" and "graduation provisions" are often unduly harsh and could be improved at relatively little cost, for example, by converting them into TRQs such that the preference ends only for exports beyond the quantities that trigger the CNL/graduation. If the benefits of extended cumulation in TPFD programs are to be realized, both for development and for the broader trading system, it is important that these other factors be addressed. Extending cumulation to all TPFD/FTAs would only partially mitigate the limitations of the GSP per se.

Within the architecture of the international trading system, one might argue that we are approaching a point of saturation of FTAs, at least to the degree that most of the important North-South trade relationships are now covered by such agreements. The next phase of regionalism seems likely to involve "convergence" and consolidation of these arrangements. The proposal in Section V of this paper would constitute an element of such convergence, and would likely help to accelerate such processes, especially if expanded to reciprocal FTAs. Most of the

[42] The "policy anchors" hypothesis is based on the idea that developing countries enter into FTAs with developed countries in order to gain credibility for domestic, market-based economic policy reforms. If the country is subject to monitoring through FTA-related institutions, the reforms are more likely to be maintained, and therefore the country will be more attractive to investment from abroad. See Ferrantino (2006)

significant non-agricultural tariff protection remaining in the world after many rounds of GATT negotiations is maintained by developing countries. These are precisely the countries that benefit from TPFD programs. Extended cumulation provisions in TPFD programs could be an important tool by which the developed countries can promote development that alters the political-economy balance in the beneficiary countries in favor of multilateral engagement.

The point of the reforms discussed in this paper is to relax the some of the limitations on international supply chains that are imposed by the preferences themselves. As preferential access to the large, developed markets moves to promote South-South trade, the costs of qualifying for preferences should fall and the incentives for engagement in the multilateral system grow. Both would promote development, and both are in the interests of all members of the international trading community.

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