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## Rules of Origin Regimes and South Asia: A Preliminary Survey of Issues

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### 1. Introduction

Determining the country of origin of traded products is an important issue in international trade as trade policy in many countries varies according to their country of origin. The question of origin has become complex in recent years due to globalization of the production process of commodities. This has resulted in a situation where most industrial goods incorporate inputs from a wide variety of countries or are being processed in different countries. It is therefore important to have well laid out Rules of Origin (RoO) to identify the country of origin in a traded product.

RoO were not greatly talked about until recently. In the late 1980s, three developments served to focus more attention on the problems posed by the RoO. First, the growth of international trade in goods that are not manufactured in a single country brought into prominence the rules for determining the 'origin' of traded products. Second, proliferation of frequently overlapping Preferential Trading Arrangements (PTAs) led to an increase in origin disputes and thus brought the RoO under focus. Lastly, as traditional trade barriers, i.e. tariffs, were reduced under GATT (and then the WTO), countries sought to use the RoO as a protectionist measure.<sup>1</sup>

RoO can be categorized as either preferential or non-preferential. The preferential RoO are those applied in the context of preferential trading arrangements (PTAs)

<sup>1</sup> Harilal and Beena (2003).

such as customs unions, free trade areas (FTAs) or even non-reciprocal arrangements like the Generalized System of Preferences (GSP). Non-preferential RoO are those used in non-preferential commercial policy instruments such as most favoured nation tariffs, anti-dumping and countervailing duties, safeguard measures, origin marking requirements, and any discriminatory quantitative restrictions or tariff quotas. The non-preferential rules also include those used for government procurement and trade statistics. Non-preferential RoO involve tracking down the production process of a commodity all the way to the country where it actually originates. On the other hand, preferential RoO are used to ensure that only the products of countries, which are party to a Preferential Trade Agreement (PTA), are granted concessional entry.

It is possible, depending on the purpose, to devise different methods to determine origin. In fact, currently a variety of methods and their combinations are in vogue among countries. According to the Kyoto Convention of 1973,<sup>2</sup> where the first attempt was made to evolve a common approach for setting the Rules of Origin, the country of origin of a product is the country where the last ‘substantial transformation’ takes place. The last substantial transformation is defined as the one that gives the commodity its essential character. The Kyoto Convention prescribed different methods of determining ‘substantial transformation’ such as (a) change in tariff heading (CTH) as a result of domestic processing of imported goods in the originating country; (b) prescribed minimum percentage of value addition in the originating country; and (c) occurrence of specified processing operations in the originating country. Though the above three criteria give some guidance, each country has the freedom to choose its own set of RoO. This complicates international trading as goods that satisfy the criteria of origin in one country may not do so in another.

Also RoO can impose economic costs depending upon how they are specified. In FTAs, trade diversion in intermediates is the immediate effect that any stringent RoO can impose upon the trading structure of preferential partners. That is, strict RoO, which require high regional value addition, might induce producers to purchase inputs domestically instead of purchasing them from abroad even if the latter are cheaper or better in quality. To meet the requirement of the RoO, producers of export products might have to change their production decisions regarding where to purchase inputs, locate production, market their products, etc. Consequently, the RoO affect producers’ cost structure, productivity and competitiveness.

Even though RoO are supposed to be used as devices to support implementation of trade policy instruments, their misuse, which has become quite rampant in recent times, transforms them into trade policy instruments per se.<sup>3</sup> It is such misuse of the RoO that necessitated the Uruguay Round (under GATT) Agreement on Rules of Origin (hereafter ARO). The ARO requires WTO Members to ensure that their RoO are transparent; that they do not have restricting, distorting, or disruptive effects on international trade; that they are administered in a consistent, uniform, impartial and reasonable manner; and that they are based on positive standards. The long-term goal of the Agreement is to harmonize non-preferential RoO (the Harmonization Work Programme – HWP).

2 Text of the original Kyoto Convention of 1973 (the revised one was in 2000), <http://www.unece.org/trade/kyoto/> (visited on July 3, 2006).

3 For instance, the high cost of compliance with the rules of origin of an importing country (administrative and technical costs involved, and the need to keep the proof of origin) by itself can act as a trade deterrent. Similar is the case of uncertainties associated with the determination of origin status that add to the risk of exporters as well as importers. A more direct use of the rules of origin as a protectionist tool emanates from the imposition of stringent local content requirements. The local content requirements invariably increase the consumption of factors of production originating in the territories of contracting parties. A regime of stringent rules of origin can also be used to attract investments into the markets of the contracting parties (Hirsch, 2002).

The RoO issue becomes complex when countries employ more than one set of RoO. The preferential RoO employed by a PTA Member more often than not differ from its non-preferential RoO. The RoO regime of the country becomes more complicated when it becomes part of many PTAs which have different sets of RoO to determine origin of imported products. This has been the case with the South Asian countries, including India, where there has been a conscious policy shift in recent years towards regional co-operation by establishing PTAs (mainly Free Trade Agreements – FTAs).

Given this context, the present study is an attempt to map out and analyse the RoO regimes in the South Asian countries. The study assumes special significance in the context of WTO's Harmonization Work Programme (HWP) on the one hand, and proliferation of PTAs in the South Asian region on the other. The South Asian region, as it has happened in many other regions, is slowly moving towards a situation in which each South Asian country has many sets of RoO owing to many PTAs it has signed. India is in the forefront of this race for concluding PTAs (mainly FTAs). Regarding the non-preferential RoO, we will discuss the contents and progress of the HWP and its probable effects on the South Asian countries. With respect to the preferential RoO, we will limit our analysis to those PTAs in the South Asian region in which India is a signatory, as it will give an indication of the situation for the entire region. India is involved in full-fledged FTAs with Sri Lanka and Nepal. It is also part of the regional FTA (South Asian Free Trade Area – SAFTA). All these have different RoO. All these instruments will be analysed along with some other Indian PTAs with non-South Asian countries. Some generalized effects of preferential RoO in the context of the South Asian region are outlined at the end.

The study is presented in five sections as follows: Section 2 introduces certain important economic effects of the RoO. Section 3 deals with the non-preferential RoO and their harmonization under the HWP. The focus in Section 4 is on the preferential RoO in the South Asian context with special reference to India. In Section 5, we bring together the important arguments of the study besides listing the policy insights emanating from it.

The present study, it needs to be mentioned at the very outset, suffers from some important limitations for which we do not have ready or easy solutions. First, the stalemate in the HWP of the WTO makes it nearly impossible to study the impact of the harmonized or common RoO on the South Asian countries. This impact cannot be fully assessed till the harmonization programme is successfully completed. Second, since the PTAs in South Asia are all of recent origin, it is not easy to make an ex-post evaluation of the impact of either the PTAs or the RoO attached to them. It will take years of accumulation of experience and data to carry out such empirical studies. In spite of such constraints, the study projects certain conclusions using the available information and data and also by drawing upon the lessons emanating from the literature – both theoretical and empirical.

## 2. Economic Effects of Rules of Origin

There is not enough literature on the RoO which assesses their economic effects. This is partly because economic theory has not come up with a ‘standard’ on the basis of which the RoO effects can be measured.<sup>4</sup> The lack of relevant statistical information and methodological difficulties (even when information is available) has also constrained the economic analysis in this area.<sup>5</sup> From the scarce literature that can be found on the subject, the following effects of the RoO emerge. We first discuss the effects of the preferential RoO and then those of the non-preferential RoO though some overlap can be easily discernible.

### 2.1 Preferential Rules of Origin

The preferential RoO are of crucial importance in the functioning of any PTA, especially in a Free Trade Agreement (FTA)<sup>6</sup> in administrating a number of trade issues and in avoiding trade deflection. In an FTA Members maintain their own external tariffs. Hence tariffs may differ between Member countries. In this setting, in the absence of the RoO, any particular commodity can enter through the country with the lowest duty on the item in question and get re-exported to other countries in the FTA.<sup>7</sup> This is trade deflection. RoO prevent such simple transshipment of goods by requiring products to originate in exporting Member countries. Thus RoO, with their potential ability to prevent trade deflection, play a very important role in FTAs.

Panchamukhi and Das (2001) state that the RoO requirements can check the import content or value addition, thereby having the potential to generate backward and forward linkages in a country adhering to these rules. These requirements act as deterrent to the assembly kind of production. The RoO thus have important implications for the development of the manufacturing sector as a whole, which in turn enhances the export supply capabilities of Member countries. However, Brenton (2005) states that with globalization and the splitting up of the production chain, countries do not have the luxury of setting up integrated production facilities anew to develop their manufacturing sector. He also points out that strict RoO for the past 20 years have not shown any instance of generating backward and forward linkages.

The RoO also present incentives to local producers to purchase intermediate goods from domestic sources, even if their prices are higher than those of identical imports from outside the FTA, so that the final export product ‘originates’ in the FTA and thereby qualifies for preferential treatment.<sup>8</sup> This effect of the RoO is more prominent if there are big differences in the external tariff regimes of the FTA/PTA Member countries. The larger the differences between their Most Favoured Nation (MFN) rates, the greater the incentive to buy high-cost inputs from an FTA/PTA Member country to satisfy the RoO and thereby obtain the duty concession on their final goods sold within the FTA/PTA. Thus trade is diverted from low-cost non-Member countries to high-cost Member countries. Krueger (1993) first pointed out this effect of the RoO. She concluded that unless consumption gains from the FTAs are high

4 Falvey and Reed (1998).

5 Hoekman (1993).

6 In a PTA, tariffs are reduced preferentially but not completely phased out as is done under FTAs. Thus FTAs are special type of PTAs in which tariffs on most products are brought down to zero.

7 Krishna and Krueger (1995).

8 Krishna (2005).

enough (because of lower prices), trade diversion leads to welfare loss of the importing country.

The preferential RoO, when restrictive, can also lead to investment diversion in the long run (Krishna 2005). They may motivate, or even force, firms to locate their plants that produce intermediate goods within the territory of certain Members of any PTA to satisfy these rules despite the fact that those territories may not be the best locations from an economic point of view. This was obvious in the case of the US company, Intel, which complained that the changes introduced by the European Community (EC) in 1989 to the RoO definition for integrated circuits ‘forced’ the company to invest in Ireland.<sup>9</sup>

From an analytical point of view, the basic effect of the RoO is to raise the production costs of the product in order to meet the binding RoO.<sup>10</sup> Thus they are welfare reducing. Falvey and Reed (2002), however, demonstrate that under certain circumstances, RoO could improve the importing country’s terms of trade and thus be welfare augmenting. Duttagupta and Panagariya (2003) use a general-equilibrium framework and show that though the RoO can improve the political viability of an FTA, their effects on welfare of the FTA are ambiguous.

The RoO are also quite expensive to document. Consequently, even if a product satisfies the RoO, an importer may prefer to pay the tariff rather than bother with the documentation needed. Herin (1986) calculated that MFN tariffs were paid on 21.5% of EFTA (European Free Trade Area) imports from the EC and 27.6% of the EC imports from the EFTA because of the burdensome documentation required to prove origin for availing preferences. More recently, Estevadeordal and Suominen (2003) estimate that the administrative cost of certifying origin is as high as 3-5% of the value of export transactions in the EFTA. Cadot et al. (2002) found that the negative effects of the RoO and other administrative compliance costs largely offset the positive effects of tariff preferences in NAFTA. Exporting sectors in Mexico in 2000 had an average rate of utilization of preferences (under NAFTA) of 64%. Under the EU’s (European Union’s) ‘Everything but Arms’ initiative, only one-third of EU imports from the Balkans that were ‘eligible’ for preferences actually entered the EU at preferential rates.<sup>11</sup> These low utilization rates suggest that the RoO are restrictive to the point where many importers forgo the preference and pay the full MFN tariff rate.

From the above discussion we find that in charting out an agreement on preferential trade if strict RoO norms are designed, it will have two immediate major effects on producers, namely:

- (a) Make some producers substitute imported inputs (from third countries) with domestic ones (even if imported inputs are cheaper or of better quality);
- (b) Make some other producers (who find substituting not efficient) not avail of the tariff preferences, which in turn defeats the purpose of the PTA.

9 Ghoneim (2003).

10 Krishna and Krueger (1995).

11 Brenton and Manchin (2002).

## 2.2 Non-preferential Rules of Origin

The insights drawn from our discussion on the economic effects of the preferential RoO are applicable to the non-preferential rules as well. In preferential trading arrangements, most often the RoO are seen as a factor offsetting the effect of the preference margin, particularly when viewed from the point of view of Members/beneficiaries. In a similar manner, the non-preferential RoO tend to add to the trade distorting effect of the principal trade policy tool for which they are used, such as tariffs under the Generalized System of Preferences (GSP). Take, for instance, the hypothetical case of an African country importing fabrics from India and making printed fabrics to be exported to the United States. If the non-preferential RoO in the USA do not recognize making of printed fabrics from fabrics as constituting a substantial transformation, which incidentally it does not, the African country would not be granted the origin status and would be denied the opportunity to use its GSP quota.

Again, identification of the country of origin of a product against which an anti-dumping or a countervailing duty is to be imposed would depend on the RoO (non-preferential). Interestingly, as the RoO vary from one country to another, the country of origin of the product and hence the country of incidence of such duties might also vary. In other words, even while retaining the anti-dumping duty or countervailing duty regime as being the same, the RoO can be manipulated to distort trade. Thus instead of acting as supporting tools for trade policy (like anti-dumping duties, etc.), the RoO may be designed in such a way that they act as a trade policy tool per se.

Another issue related to the non-preferential RoO is the criteria applied to determine whether a good is of domestic origin or not. Can the same set of rules, used to determine the foreign country of origin of a product, be applied to determine whether a product is of domestic origin or not? The criteria, in fact, differ in many countries. However, the Agreement on Rules of Origin (ARO) insists that the RoO, that the WTO Members apply to imports and exports, should not be more stringent than the RoO they apply to determine whether a good is of domestic origin or not (Article 1 of the ARO). In other words, the RoO to determine whether or not a good is of domestic origin should be either as stringent or more stringent than the RoO applied to exports and imports.

In any case, the origin rules applied to determine whether a product is of domestic origin or not would have far-reaching implications for commercial policy. They could be effectively used to protect selected domestic sectors/industries.<sup>12</sup> Suppose the US government is keen to protect domestic producers of upstream textile products such as yarn and fabrics. The government can frame the RoO to determine the 'domestic status' in such a way that textile and clothing producers in the US use yarn or fabrics produced in the US. Textiles and clothing products produced in the US using imported yarn or fabrics could be denied 'domestic status' by way of origin rules with stringent domestic content requirements. So much so that to ensure the 'domestic status' and thereby to avoid stiff tariff and other border measures, the US producers of textile and clothing products would source their yarn or fabric inputs from the US

12 Vermulst (1997) speaks about the difference in the RoO employed to determine the domestic status in the context of anti-dumping duties and government procurement.

manufacturers rather than from lower-cost external sources. In this way, the RoO can be used to insulate domestic industries from outside competition.

As for theoretical insights, the issue involved is quite similar to that of domestic content requirements practised by many countries which specify the share of domestic content in production. Failure to meet these requirements results in a penalty tariff on inputs for domestic producers or a penalty tariff on the import of the final good if the final good is imported. Content protection policies have been previously analysed in the literature.<sup>13</sup> Even though the effects of content protection are context-specific, one of the most probable outcomes is an increase in the protection level granted to the domestic input producing industry. However, while the content protection causes substitution towards domestic inputs, it also raises the cost and hence the price of the final good. Therefore, the content protection schemes might not be very attractive from the point of view of the domestic final good industry.<sup>14</sup>

Previously there was an established trend in the world of commercial policy that the developed countries would give more protection to their final goods by way of escalation of trade barriers across processing chains. The consequent high level of effective protection granted to the final goods producers by the developed countries continues to be a major source of worry for the developing country exporters till this day. However, in some sectors like textiles and clothing, the developed countries are now keen to protect the upstream activities.

The RoO are potential trade policy weapons in pursuing the goal of protecting the producers of intermediate goods. Generally a country, which wants to protect an intermediate good producing industry, would prefer stringent RoO for the final good, thereby tracing its origin to the country of production of the intermediate good. On the contrary, a country which does not produce intermediate goods, and whose final goods industry is dependent on imports, is likely to favour more liberal RoO for final goods, and is unlikely to support provisions tracing the origin of final goods to the intermediate goods producing country.

Another important feature of protectionism based on the RoO is the so-called 'privatization' of trade policy. Individual industries and concerned industrial lobbies play a very important role in determining the level of protection granted in the case of most of the new, contingent forms of protection, including the RoO. The level of protection would depend largely on the persuasive skills and strengths of the industrial lobbies. Contextually, US textile lobbies are known to have played an important role in framing highly restrictive US and NAFTA RoO in the area of textiles and clothing.<sup>15</sup> The cumbersome administrative process involved, and the scope of involvement by the import competing interests, makes the system less predictable as well as less transparent when compared to overt methods of protection.<sup>16</sup>

Given these general effects of RoO, the next two sections discuss issues related to both preferential and non-preferential RoO in the specific context of the South Asian region.

13 Corden (1971).

14 Further, since the demand for inputs is a derived demand, the adverse impact on the final goods industry would get ultimately transferred to the input producing industry as well.

15 Hoekman (1993).

16 Palmeter (1993) and Hoekman (1993).

### 3. Non-Preferential Rules of Origin and their Harmonization: Probable Impacts on South Asia

Until recently, origin disputes were practically alien to the South Asian region. In fact countries in the region, as they have notified to the WTO Committee on RoO (CRO), did not have any well-defined system of rules for determining the country of origin of traded products. This does not mean that the customs authorities in these countries were indifferent to different sources of origin of their imports. In order to implement discriminatory commercial policy tools, as well as for non-discriminatory motives such as collection of statistics, the customs had to determine the nationality of origin of traded products. But this was done according to the customs and traditions of the department, which scarcely produced origin disputes because origin of products was more or less obvious before the advent of globalization of production. Even though globalization of production has made the question of origin more complex, it was the emergence of the PTAs that made governments in the region formulate the RoO (preferential RoO). As for the non-preferential RoO, WTO's Harmonization Work Programme (HWP) is expected to come up with common and harmonized rules for all Member countries of the organization.

Harmonization of the non-preferential RoO is one of the most ambitious and perhaps the most technically oriented tasks that the WTO has undertaken since its inception in 1995. However, in spite of several years of intense negotiations and the massive amount of work undertaken by the CRO and the Technical Committee on Rules of Origin (TCRO), the task of harmonization remains far from complete. The HWP was supposed to be completed by July 1998, three years after its launch in July 1995. The deadline was extended several times by the General Council, but the extended deadlines passed without the completion of the HWP. The General Council at its meeting on July 27, 2005, extended the deadline for the completion of negotiations on 94 core policy issues until July 2006.<sup>17</sup> The General Council also agreed that the CRO, following resolution of the core policy issues, should complete its remaining technical work by the end of 2006. It is therefore premature to attempt a comprehensive critique of the HWP, leave alone critiquing Harmonized Rules of Origin. However, the progress made so far, as outlined here, prompts a critical analysis of the HWP from the perspective of South Asia.

#### 3.1 Goods Wholly Obtained in One Country

An important achievement of the HWP so far has been the Integrated Negotiating Text (INT) which lays down the overall architecture of the harmonized non-preferential rules of origin. The INT defines goods that are to be considered as being wholly obtained in one country, minimal operations, substantial transformation through change in tariff classification and/or supplementary criteria. The INT contains, besides the general rules, two appendices; one on the harmonized rules pertaining to wholly obtained goods, and second dealing with product-specific rules of origin.

17 WTO (2006).

Except for two important outstanding issues, there is broad consensus among Members regarding harmonized definitions of the goods which are to be considered as being wholly obtained in one country. Appendix 1 of the INT<sup>18</sup> presents an exhaustive list of the goods that are to be considered as being wholly obtained in one country, such as:

- (a) Live animals born and raised in that country;
- (b) Animals obtained by hunting, trapping, fishing, gathering or capturing in that country;
- (c) Products obtained from live animals in that country;
- (d) Plants and plant products harvested, picked or gathered in that country;
- (e) Minerals and other naturally occurring substances extracted or taken in that country;
- (f) Scrap and waste derived from manufacturing or processing operations or from consumption in that country and fit only for disposal or for the recovery of raw materials;
- (g) Articles collected in that country which can no longer perform their original purpose there nor are capable of being restored or repaired and which are fit only for disposal or for the recovery of parts of raw materials;
- (h) Parts or raw materials recovered in that country from articles which can no longer perform their original purpose nor are capable of being restored or repaired;
- (i) Goods obtained or produced in that country solely from products referred to in (a) through (h) above.

When we add the definition of minimal operation and process (Rule 2) to the above list of wholly obtained goods, we get a fairly comprehensive harmonized definition of the wholly obtained goods. Minimal operations and processes are defined as follows:

Operations or processes undertaken, by themselves, or in combination with each other, for the purposes listed below, are considered to be minimal and shall not be taken into account in determining whether a good has been wholly obtained in one country: (1) ensuring preservation of goods in good condition for the purposes of transport and storage; (2) facilitating shipment or transportation; (3) packaging or presenting goods for sale.<sup>19</sup>

However, there is no consensus on the issue of origin of recovered parts from collected articles (which can no longer perform their original purpose – e.g. discarded computers). The two options are to confer the origin either to the country where the articles are collected, or to the country where the parts are extracted. But the above rules were not acceptable to some Members because recovery of parts from collected articles might also release radioactive, hazardous and toxic waste, the disposal of which could emerge as a major environmental problem. Another problem that eludes

18 WTO (2002b).

19 WTO (2002b).

consensus is the question of origin of fish and other products taken from the Exclusive Economic Zone (EEZ). There is agreement among Members that the origin of fish and other products taken from the territorial sea (not exceeding 12 nautical miles) of a country should be the coastal state. It is also agreed that the origin of fish and other products taken from the high seas should be the country whose flag the vessel that carries out these operations is entitled to fly. However, disagreement persists in the case of fish and other products taken from the EEZ.<sup>20</sup> While countries like India maintain that the origin of fish and other products taken from the EEZ should be the coastal state, the USA, the EEC, Japan, Canada, and some other countries insist that the origin should go to the country of the flag of the vessel.<sup>21</sup> The interest of the latter group of countries is to have an international fishing area as large as possible with origin of the products determined by the flag of the ship, whereas the former group wants to keep full control over the resources in their waters.<sup>22</sup>

### 3.2 Substantial Transformation: Product-specific Rules

Most of the road-blocks to the HWP are to be seen in the attempt to evolve product-specific RoO, which put forward specific criteria for substantial transformation. In June 1999, when the TCRO submitted the final results of its technical work in this regard, there were 486 outstanding product-specific issues to be considered by the CRO. The CRO could resolve many of them. However, since the rest of the outstanding issues were difficult to be dealt with at the committee level, the CRO had referred them to the General Council for discussion and decision. Out of 94 core policy issues referred to the General Council, 92 were related to the product-specific rules. In the two other issues referred to the General Council, one was the question of origin of fish and other products taken from the EEZ. The other was the implications of the implementation of the Harmonized Rules of Origin for other WTO Agreements.

Regarding the outstanding product-specific issues, it is difficult to generalize on the nature of disputes and the position taken by the Members. What will or will not qualify

20 WTO (2002c).

21 *ibid.*

22 Nell (1999).

**Table 10.1 Conflicts over defining substantial transformation of products: An illustration**

Process	India	USA
Green coffee is processed through roasting into roasted coffee	It is not substantial transformation	It is substantial transformation
Cocoa beans transformed into cocoa paste by roasting, winnowing, alkalisation and grinding	It is not substantial transformation	It is substantial transformation
Fruits or vegetables are processed through extraction into juices	It is not substantial transformation	It is substantial transformation
Crushing/grinding of spices	It is not substantial transformation	It is substantial transformation
Making dyed or printed yarn from yarn	It is substantial transformation	It is not substantial transformation
Making dyed or printed fabrics from fabrics	It is substantial transformation	It is not substantial transformation

for substantial transformation is the central question of conflict almost in every case. But a perusal of the positions taken by Members across product groups brings out lack of consistency in their approach to the question of substantial transformation. The information presented in Table 10.1 illustrates the conflicting positions taken by countries. For instance, the US, which insists on stringent norms in the area of textiles and textile articles, is rather reluctant to accept such a rigid approach in the case of many tropical products. India's position in the cases cited above is exactly the reverse of that taken by the US. India, which opposes harsh norms in the area of textile and textile articles, is all for stricter norms for tropical products. Such inconsistency in approach by which countries refuse to follow general norms and broad principles in a consistent manner is widely noted among the WTO membership.

The reasons behind such inconsistencies in the position of countries are not far to seek. The most important among them is the influence of trading interests. The negotiating positions of countries across product sectors are determined by the corresponding national trading interests rather than by any common principle to be adopted in a uniform manner. The remaining outstanding issues represent the hard-fought and long-held positions of Member countries involving big stakes. An early resolution of the outstanding issues might, therefore, require involvement of the General Council or even the Ministerial Conference.

None of the factors that tend to make the RoO a contested terrain, namely, internationalization of production, increasing incidence of discriminatory trade policy tools that require well-defined rules to determine nationality of origin of commodities, and the growing tendency to make use of the RoO as protectionist tools per se are likely to decline in importance in the foreseeable future. On the contrary, each factor is likely to grow in importance over time making the RoO the sites of growing trade policy conflicts among nations. The ARO, therefore, has come none too early. It is important that the ARO succeeds in its fundamental goal of establishing a multilateral regime for RoO lest the anarchy, that is likely to break out in its absence, endanger the framework of international division of labour.

The central limitation of the ARO and the HWP is their inability to address the most important issue, namely, the tendency to use the RoO as discriminatory trade policy tools per se. Take first the case of discrimination among foreign suppliers. The most important sources of such discrimination in today's world, undoubtedly, are the PTAs. But, as we have already seen, the preferential RoO are not in the purview of the HWP. The misuse of the RoO as a protectionist tool is quite rampant among the PTAs. In fact, as we have mentioned earlier, it was the proliferation of the PTAs that had led to the proliferation of the RoO. It is quite common for individual countries to join several PTAs, representing a hierarchy of privileges and preferences. All these, it is widely argued, contribute to the uncertainties and risk of traders. It is no exaggeration to say that the originating status would vary not only according to destination of exports but also depending on the preferential regime that the exporters choose to avail.

The excuse for the exclusion of preferential RoO could be that they affect only the PTA Members/beneficiaries. But, as we have already seen in Section 2, the RoO of the PTAs could act as stiff non-tariff barriers against non-Members. The PTAs can employ the RoO, as many of them do, to scale up barriers to imports from non-Members. This, it needs to be underlined, is against the spirit of Article XXIV of GATT, which permits establishment of the PTAs. The purpose of such preferential agreements, as Article XXIV makes clear, 'should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other members'. As such, if the declared objective of the WTO, that of eliminating trade distorting effects of the RoO, is to be achieved, it should be addressing the question of preferential rules, if not now, in the near future. The developing countries should perhaps insist first on documenting all preferential rules of origin and then on periodic negotiations for making them less stringent.

As far as the impact on the South Asian countries is concerned, the exclusion of preferential rules from the harmonization programme would not be very advantageous to these countries in improving their market access to the PTAs among developed countries. The PTAs such as EEC, EFTA and NAFTA will continue to misuse the RoO to protect domestic production as they do now. But, the exclusion of the preferential rules from the HWP would enable the South Asian countries also to make preferential rules of their choice in the PTAs that they establish. This is particularly important because the PTAs involving the South Asian countries are of relatively new origin. Since the new PTAs are likely to be characterized by relatively high inter-country differences in tariffs, they are likely to be more vulnerable to trade deflection. However, it is advisable that the PTAs among the developing countries also desist from the temptation to revise the RoO periodically to make them more stringent.

Another reason for our pessimistic note on the proposed international regime on the RoO is the inbuilt need for periodic revision and the scope that it entails for 'privatization' of trade policy making. This criticism is applicable to both the preferential and non-preferential RoO. Internationalization of production and the accompanying technological changes would require periodic revision of the RoO, especially in product groups where technologies and production processes change fast.

The process of technological change also presupposes periodic revision of the Harmonized System of Trade Classification. The changes in the HS nomenclature, therefore, will be another reason for undertaking periodic revision of the RoO. Interestingly, therefore, the HWP and the conflicts that it entails are likely to be a permanent feature of the WTO in the future. The need for periodic revision and the consequent uncertainty regarding the RoO might strengthen the tendency of 'privatization' of trade policy. It would also add to the burden of negotiators from the developing countries including the South Asian nations. Even though Article 6 of the ARO provides for the introduction of amendments to the harmonized rules, procedures for the same are yet to be evolved. In view of the threat of misuse and 'privatization', it is important that detailed procedures for moving the amendments are clearly laid out.

It is contextual here to mention the increasing incidence of violation of transition disciplines spelt out in Article 2 of the ARO. In the transition period, Members are not expected to introduce new rules of origin, or changes in the existing regimes, which are likely to be used as instruments to pursue trade objectives directly or indirectly. However, instances of violation of such interim disciplines are increasing. An instance worth a particular mention here is that of the change introduced by the US to its RoO for textile and apparel products, which entered into force on July 1, 1996. The US action, being highly protectionist, led to demands for consultation by many Members, including India and the EEC.<sup>23</sup> Incidentally, the issue taken later to the dispute settlement body by India was settled in favour of the US.<sup>24</sup> Further delay of the HWP is likely to lead to such RoO-based protectionist moves from Member states. There is, therefore, a clear case for negotiating an understanding to keep status quo (a standstill understanding) in the case of the RoO till the HWP is completed.

Further, there are many reasons to fear that the new multinational regime would be biased against the interests of the developing countries. We have already mentioned two such possibilities, viz., exclusion of the preferential RoO, and the threat of periodic revision that leaves scope for the so-called 'privatization' of trade policy making. Both these factors, given the size and strength of PTAs among the developed countries, and the bargaining power of industrial lobbies from the West, are likely to have adverse implications for the developing countries. Coming to more substantial reasons, since the non-preferential rules of origin under the HWP are supposed to be common to all WTO Members, the scope of discrimination would appear to be limited. But, as we shall try to illustrate, the proposed regime of common RoO is no guarantee for equal treatment.

Before explaining as to how the common rules can be discriminatory, it is important to note that the new regime denies special and differential treatment to the developing countries. Individual developing countries will not have the right to make a deviation from the common rules to suit their stage of development. Interestingly, this is in contrast to most other Agreements of the WTO, which are known to factor the question of development into their framework. In our opinion, the developing countries have a case for demanding the right to deviate from common RoO, wherever such concessions are justifiable in terms of special and differential treatment.

Coming back to the question of discrimination, it should be emphasised that while the harmonized rules are common for individual product groups across countries, they differ significantly between product groups. In some product groups, the common rules are very simple, while in some others these are very stringent. This difference across product groups arises out of varying perceptions regarding what will or will not qualify for substantial transformation. As we have already seen, there are no universal rules or commonly accepted criteria for determining substantial transformation. The criteria proposed by the TCRO and the CRO vary significantly across products. As such, a clear idea on the regional impact would require product-specific studies to be undertaken with respect to all important commodity groups of the region.

23 WTO (2002a).

24 Prata (2003).

An illustration in terms of textiles and clothing would be meaningful in the context of the WTO Agreement on Textiles and Clothing. The South Asian countries were expected to make significant gains from the MFA phase-out.<sup>25</sup> But, in the post-integration phase, the developed countries had resorted to the tariffs in a significant manner to protect their textiles and clothing producers. It is also possible that the developed countries would be resorting to a variety of covert protectionist tools such as anti-dumping and countervailing duties to ward off competition from the third world. What is more significant in our context is the likelihood of the RoO emerging as a highly potent protectionist weapon. We have already seen indications of the same in NAFTA as well as in Section 334 of the Uruguay Round Agreements Act, 1996 of the United States. The US move, supported by the developed countries, is to influence the HWP so that the home spun and highly protectionist RoO are imposed on the community of nations.

Free trade owes many of its virtues to specialization. But, an important feature of the US proposals on the RoO in textiles and clothing, which we highlight here, is their anti-specialization bias. Over many centuries, the textiles and clothing industry has evolved quite an intricate pattern of international specialization. There are countries and regions which specialize in one or many combinations of activities such as spinning, weaving, bleaching, texturing, dyeing, printing, coating, impregnating, embroidery, making of made-up articles, assembly of garments, etc. There are countries which do not produce any yarn or fabric but maintain a strong presence in the industry and trade by virtue of their comparative advantage and specialization in other activities. But, if the developed country proposals are accepted, many such activities/avenues of

25 Wijayasiri (2003).

**Table 10.2 Selected origin disputes in textiles and clothing**

Process	India	USA
Dyeing or printing of yarn	Permanent dyeing or printing alone can be considered as substantial transformation	A yarn of one country that is dyed and/or printed in another country should not be considered as originating in the latter country
Dyeing or printing of fabrics	Permanent dyeing or printing alone can be considered as substantial transformation	Neither dyeing nor printing alone, nor dyeing and printing together result in substantial transformation
Coating fabrics with rubber or plastics	Coating of rubber or plastics can be considered as substantial transformation	Coating of fabrics with rubber or plastics cannot be considered as origin conferring
Making embroidered flat products from fabric	Substantial transformation if the value of non-originating materials does not exceed 50% of the ex-work price of the product	Country of origin shall be the same as the country of origin of fabric
Parts knitted or crocheted to shape are processed through assembling into apparel	Considers as substantial transformation	Does not consider as substantial transformation

Source: WTO (2002c).

specialization will not by themselves meet the criteria of substantial transformation/origin status. The situation would be so bad that the origin of yarn and fabrics, regardless of dyeing, printing and so many other processing operations done elsewhere, would be traced back to the country of spinning or weaving.

A brief account of some origin disputes, presented in Table 10.2, would make the competing positions clear. Keeping in tune with the history of evolution of the industry, and its present international structure, India and other developing countries in general recognize each such activity/avenue of specialization as substantial transformation requiring shift of origin. On the contrary, the developed countries, led by the US, refuse to recognize many key processes/avenues of specialization as substantial to cause shift in origin. For them, origin of textiles and clothing products should be traced back, as far as possible, to the country of origin of yarn or fabric.

The implications of such a regime would be highly trade distorting. The export of textile articles from other developing countries, which source yarn or fabrics from India or Pakistan, would be counted as originating from India or Pakistan! The new rules might also make administration of trade more cumbersome and costly. A related problem is that of targeting trade policy tools such as anti-dumping and countervailing duties. Suppose anti-dumping action is to be taken against a country 'A' exporting printed fabrics and made-up articles using fabrics imported from another country 'B'. According to the US proposals, the anti-dumping and countervailing duties would be charged on the country of origin which would be 'B' not 'A'. Further, in the case of many products of textiles and clothing, it will be difficult to trace the country of origin of yarn or fabrics used in their making. In fact, the country of origin of a product produced by a given firm might go on changing according to the changes in the source of inputs. Accordingly, the manufacturer will also be forced to change the marking of origin. Last but not the least is the bias against specialization: countries specializing in processing operations such as dyeing, printing, etc. will be denied originating status. In the process, it would also make protection of intellectual property rights (IPRs) related to the processing activities (e.g. IPRs on designs) difficult. Such countries, which are denied originating status, might also fail to attract investment.

If the US proposals of non-preferential rules were to be used for determining domestic status, it would give a discriminatory advantage to the domestic producers vis-a-vis foreign sources of yarn and fabrics. Take for instance the case of US manufacturers of printed fabrics. If they import fabrics for printing from India, they could be denied the domestic status. Their products could be treated as being of foreign origin and made liable to pay the customs duty. As such, regardless of the price advantage of the Indian source, the US firms might source their inputs from within the country.

Admittedly, the impact of common rules would vary significantly across the South Asian countries. Upstream protection in the developed countries would tend to affect India and Pakistan more than other countries in the region. India and Pakistan are leading exporters of yarn and textile products. Further, yarn and textile products are leading items in the export baskets of India and Pakistan. Smaller countries in the

region, however, do not export much yarn or fabrics. But, the fact that they specialize in downstream products is no consolation for countries like Bangladesh or Sri Lanka. Some of the processes in which they specialize might not be origin conferring. Therefore, if the US proposals are accepted, they will also be under pressure to make many adjustments to cope up with the new rules.

Obviously, in textiles and clothing India prefers more liberal RoO than those proposed by the developed countries. But, this does not mean that it would be in the interest of India to demand relatively liberal RoO across all product groups. There are many product groups in which India and for that matter other South Asian countries prefer stricter RoO than those proposed by the developed countries. For instance, as we have illustrated in Table 10.1, India, which opposes harsh norms in the area of textiles and textile articles, is all for stricter norms for tropical products. In the case of most tropical products and their derivatives, India prefers to have rules which trace the origin to the country in which the plant grew. However, for the developed countries, even minor processing activities such as crushing or grinding of spices is origin conferring!

Even though tropical products are produced mostly in the developing countries, they end up specializing mainly in the lower stages of the processing/value chain. This pattern of specialization is explained mainly in terms of escalation of tariff and other barriers across processing chains in developed country markets. Interestingly, the liberal RoO, proposed by the developed countries in the area of tropical products, would tend to reinforce the above legacy of specialization. Therefore, the developing countries have sound reasons for demanding stricter rules of origin for tropical products. Further, their argument that the country where the plant grew, which determines many an essential attribute of the tropical products and their derivatives, should be recognized, has implications for possible geographical indications in such products. This assumes special significance in the context of the demand that the additional protection conferred for geographical indications on wines and spirits be extended to other products, particularly those of interest to the developing countries. Interestingly, the EEC has been stubborn in the negotiations that the origin of wine, whether produced from grapes or grape must, shall be the country in which the grapes grew.<sup>26</sup>

It is clear that commercial policy objectives of countries, and therefore their preferences regarding rules of origin, would vary across product groups. Therefore, for studies on the implications of the new regime, there are no short-cuts other than detailed product-specific studies of alternative proposals of rules of origin. Nevertheless, a perusal of positions, taken by countries in the harmonization negotiations, prompts us to make the following observations. Mostly countries, when they want to protect an intermediate goods-producing industry, prefer stringent RoO for final goods, tracing the origin to the country of production of intermediate goods. On the contrary, if the final goods industry is dependent on the import of intermediates, particularly when import-competing production of intermediates is absent, they favour more liberal RoO for the final goods, and do not support provisions tracing the origin of the final goods to the intermediate goods-producing country. But, obviously, common rules

**Table 10.3 Product-specific rules: Distribution of outstanding issues**

HS Chapters	Description	No. of outstanding issues
1-24	Live Animals, Animal Products, Vegetable Products, Animal or Vegetable Fats, Oils, Prepared Food Stuffs, Beverages, etc.	45 (49)
25-27	Mineral Products	2 (2)
28-40	Chemicals and Plastics	3 (3)
41-43	Raw Hides, Skins, Leather, Travel Goods, etc.	2 (2)
50-63	Textiles and Textile Articles	24 (26)
64-67	Footwear, Headgear, Umbrellas, etc.	4 (4)
72-74	Iron and Steel, Copper and Articles thereof	2 (2)
84, 85, 90	Machinery and Electrical Appliances, Optical Instruments, etc.	9 (10)
91	Clocks and Watches and Parts thereof	1 (1)
All Chapters		92 (100)

Note: Figures in parentheses in the last column indicate percentage shares in total outstanding issues (i.e. 92).

Source: WTO (2002c).

would mean that all countries couldn't have RoO of their choice. The choice among alternative proposals, especially in the absence of theoretically informed norms, will depend much on the balance of political and economic power of contending parties. The question, therefore, boils down to the ability of individual nations, or their groups such as that of the developing countries, to influence the process of rule setting.

Regarding the harmonized definition of wholly obtained goods, it is important that we mention the issue of control of maritime resources, which is of overwhelming significance to South Asia. Among the South Asian countries, India, Pakistan, Sri Lanka and Bangladesh possess long coastlines. As such it is in their interest to retain full control over the resources of their waters. India's position in this regard, that the origin of fish and other products taken from the EEZ should be the coastal state, represents an interest which the countries of the region can hardly compromise.

Interestingly, most of the outstanding product-specific issues, as shown in Table 10.3, are of export interest to the developing countries including those of the South Asian region. Agricultural products (45) and Textiles and Textile Articles (24) together account for 69 out of the 92 product-specific issues transferred to the General Council by the CRO. Even other areas, listed as disputed, are of export interest to the developing countries. It cannot be dismissed as an instance of sheer coincidence that a lion's share of the outstanding issues belongs to the traditional areas of western protectionism. It may also be underlined that agriculture, textiles and textile articles, which account for 75% of the outstanding issues, were outside the GATT disciplines until recently. As a result of the Marrakesh Agreement, both agriculture and textiles

are being brought back to the purview of free trade disciplines. As such the developed countries are required to phase out overt trade barriers in those areas of world trade. There is also a widely held fear that the developed countries would try to compensate for the loss of such overt measures by resorting to contingent forms of protection. Even though it is too early to say whether such bunching of outstanding disputes signifies a re-emergence of old agricultural and textile protectionism, such fears cannot be completely ruled out.

#### 4. Preferential Rules of Origin in PTAs Involving India and Implications for South Asia

Here we discuss first the RoO of Indian PTAs. Then we venture to jot down some implications for South Asia as a whole. Incidentally, India is a common Member of most PTAs involving the South Asian countries. Thus our discussion on the RoO of Indian PTAs would be generally applicable to other South Asian countries also.

The first PTA being signed by India was an FTA, the Indo-Sri Lanka Free Trade Agreement (ISLFTA). It was signed on December 28, 1998 and is in operation from March 2000. There are many more PTAs signed or in operation. A summary of all such PTAs is given in Table 10.4. (The PTAs which have not designed their RoO yet

**Table 10.4 India's current engagement in PTAs having RoO provisions**

PTA	Date of signing	Status
India-Sri Lanka FTA	December 1998	In operation since March 2000
India-Nepal PTA <sup>1</sup>	March 2002	In operation since March 2002
India-Afghanistan PTA	March 2003	In operation since May 2003
India-Thailand FTA	October 2003	Tariff concessions on EHS <sup>2</sup> started from September 2004
South Asia FTA	January 2004	In operation since July 2006
India-MERCOSUR PTA	January 2004	Awaits ratification in MERCOSUR countries
India-Singapore CECA <sup>3</sup>	June 2005	In operation since August 2005
India-Chile PTA	March 2006	Awaits ratification from both sides

Notes: 1 India-Nepal Treaty of Trade signed in 1996 gave preferential access to Nepalese goods on a non-reciprocal basis. It was extended in 2002 for 5 more years with detailed RoO clauses which were not present in the original treaty.

2 For elimination of tariff on a fast track basis, the Early Harvest Scheme (EHS) on 82 items of export interest to both sides was agreed as a confidence-building measure.

3 While a PTA/FTA usually involves structured reduction in tariffs of commodities, a CECA (Comprehensive Economic Cooperation Agreement) in addition covers trade in services. Preferential relaxation of FDI rules vis-a-vis the partner country, tax holidays on investment and income, and easing of visa restrictions also are included under the CECA purview.

Source: From various documents on PTAs available on the website of the Department of Commerce, GOI, [http://commerce.nic.in/india\\_rta\\_main.htm](http://commerce.nic.in/india_rta_main.htm)

are not discussed here, e.g. ASEAN-India FTA, BIMSTEC FTA.) Further, the RoO of these different PTAs (the primary rules)<sup>27</sup> are detailed in Table 10.5.

All the Agreements (except India-MERCOSUR PTA) include CTC (Change in Tariff Classification) at heading level (4-digit), implying all non-originating inputs must be of a different tariff classification at HS 4-digit level than the finished product. Regarding DVA (Domestic Value Added), there is variation in the permitted amounts across different Agreements (30% to 60%). DVA is the amount of value added to the finished product in the exporting Member country. It is calculated as

$$\text{DVA} = \frac{\text{FOB value of the export product} - \text{value of non-originating materials}}{\text{FOB value of the export product}} \times 100$$

The FOB (Free on Board) value includes the value of packaging of export product (other than containerisation) and excludes Cost Insurance Freight (CIF) for the over-seas route. The value of imported materials (non-originating materials) will be either the CIF value at the time of importation of the materials, or the earliest ascertainable

27 The RoO for wholly-obtained products are similar amidst most agreements and do not differ much from their non-preferential counterparts. So here we analyse the RoO given for manufactured goods.

Table 10.5 Rules of Origin in PTAs involving India

PTA	RoO provisions				Number of pages of RoO
	CTC	DVA	TECH	Cumulation	
India-Sri Lanka FTA	Yes	35%	No	Yes 25% (35%)	5
India-Nepal PTA	Yes	30%	No	No	3
India-Afghanistan PTA	Yes	50%	No	Yes 30% (40%)	6
India-Thailand FTA	Yes	40%	Yes	Yes (40%)	19
South Asia FTA	Yes	40%*	Yes	Yes 20% (50%)	23
India-MERCOSUR PTA	No	60%	No	Yes	21
India-Singapore CECA	Yes	40%	Yes	Yes	54
India-Chile PTA	Yes	40%	No	Yes	20

Notes: Figures in parentheses in the cumulation column indicate total regional value addition.

\* SAFTA RoO DVA is different for different Member countries and is given in Annexure I. For India it is 40% DVA.

Source: From the RoO provisions in various documents on PTAs available on the website of the Department of Commerce, GOI, <http://commerce.nic.in/>

price paid for them in the territory of the exporting Member country. In the latter Agreements that India has signed, product(/sector)-specific rules (technical requirements-TECH) are also included. The India-Singapore CECA has 39 pages of product-specific rules!

Bilateral cumulation provisions are also included in all the Agreements (except the one with Nepal). Cumulation provisions allow producers of a country to count materials purchased from outside the country as originating in their country for the purpose of determining the origin of their traded goods. Bilateral cumulation is the simplest form of cumulation, whereby materials from partner countries are allowed to be used as originating inputs. Due to bilateral cumulation in some cases, the DVA level is reduced, for example, in ISLFTA, bilateral cumulation allows the DVA to be 25% instead of the usual 35% provided that the total regional value added (i.e. both partners' input value along with domestic value added) is not less than 35% (the figure given in parentheses in Table 10.5). In some Agreements (the ones which are negotiated recently), bilateral cumulation does not reduce the DVA; only it is specified that an exporter can use the other partner's inputs and consider it to be originating in its own country for further DVA calculations.

There are two additional rules in all these Agreements. First, the final manufacturing process must be done in the territory of the exporting country. Second, products should be directly consigned from the exporting country to the importing country. Direct consignment means that the exported products are transported to the importing country without passing through the territory of any other non-Members. If a product's transport involves transit through one or more intermediate non-Member countries, it will be allowed provided: the transit entry is justified for geographical reason or by considerations related exclusively to transport requirements; such products have not entered into trade or consumption in the country of transit; the products have not undergone any operation there other than unloading and reloading or any operation required to keep them in good condition; and the products have remained under the customs control in the country of transit.

Responses to the RoO are time dependent. These PTAs have come into force quite recently. Given the short period and keeping in mind the year-to-year fluctuations in bilateral trade flows, we cannot hope to get a very clear picture of the RoO effects. Trade diversion effects are difficult to measure. Also it is difficult to quantify the effects of RoO and separate them from the effects of preferential tariffs. Thus it is not easy to evaluate the RoO of a particular agreement.

To overcome this problem, the RoO regimes can be subjected to a comparative analysis employing an index measure. An index approach can assess the restrictiveness of policy instruments whose impact on price and quantity is not easily obtainable. Such an index can quantify prevailing restrictions into a summary measure to facilitate comparisons on a common basis across PTAs. Index methodologies have been applied to analyse origin rules in NAFTA and European Union-related agreements.<sup>28</sup> Indices developed in these studies have focused only on particular provisions of the RoO. A

more comprehensive index measure was developed by the Australian Government's Productivity Commission<sup>29</sup> in 2004 while trying to assess economic problems with the operation and design of the RoO under the Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA).

This index methodology involves specifying a regimen of provisions or criteria used to determine origin in a PTA, a weight for each criterion reflecting its relative importance in the index and a score reflecting the restrictiveness of the variant implemented in the RoO regime. The index value lies between zero and unity. A higher index value (closer to unity) indicates a more restrictive trading environment on account of the RoO. We used the index methodology to assess the restrictiveness index of India-Sri Lanka FTA RoO.<sup>30</sup> The aggregate restrictiveness score for ISLFTA RoO turns out to be 0.536. On a comparative scale this indicates that ISLFTA RoO are restrictive enough as is evident from Figure 10.1. Compared with levels of restrictiveness identified in other PTAs, ISLFTA RoO appear to be relatively more restrictive. EU-Poland, MERCOSUR and NAFTA are the only PTAs having more restrictive RoO than those present in ISLFTA. ISLFTA RoO is fourth in rank from the high end.

Most PTAs, considered in the Productivity Commission study, allow for supplementary rules to the main methods of origin determination; for example, provisions that go beyond cumulation, duty drawback, etc. In ISLFTA, cumulation is the only supplementary rule that is provided to escape the strictness of the main methods of origin determination. Also most PTAs do not specify geographic location of the last manufacturing process to be the exporting country as is asked in ISLFTA RoO. Thus on these counts, ISLFTA has become more restrictive as far as its RoO are concerned.

28 Estevadeordal (2000), Brenton and Manchin (2002), Augier et al. (2003), and Estevadeordal and Suominen (2003).

29 The Productivity Commission, an independent agency, is the Australian Government's principal review and advisory body on microeconomic policy and regulation.

30 Jha (2005).

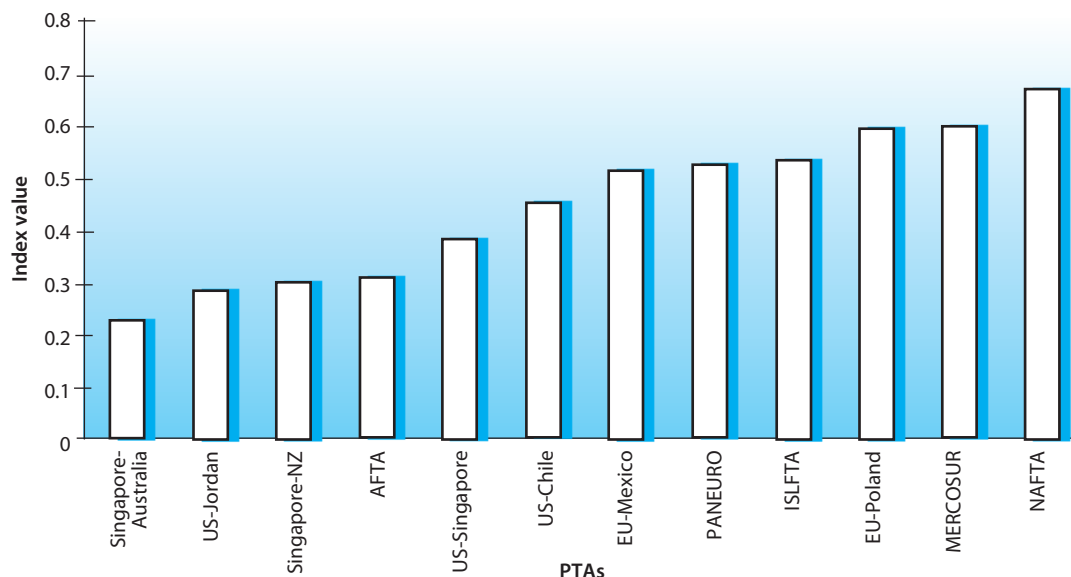


Figure 10.1 Restrictiveness Index of RoO across different PTAs.

ISLFTA has one of the simplest RoO regimes that has been designed with respect to Indian PTAs. It consists of only five pages and contains only two main methods of origin determination: CTC and DVA. Most of the latter PTAs consider TECH also and many more issues (even though India-MERCOSUR/India-Chile PTA do not have the product-specific rule, they have long-drawn RoO provisions with a lot of complex jargon). None of the latter Agreements provided for supplementary rules other than cumulation. Also DVA levels are higher for these latter PTAs. Thus we can safely conclude that on a comparative scale, the RoO associated with all other Indian PTAs have higher restrictiveness as compared to ISLFTA.

From the above analysis of the RoO of Indian PTAs, some points can be noted for specific policy focus in the South Asian context. A series of overlapping PTAs with different RoO are becoming increasingly common in South Asia. Thus it is becoming difficult for individual producers to keep records of RoO requirements, and to cope with the complications associated with them. A producer, who faces different RoO in different FTA partners, will have to produce with a different input mix for different markets if the products are to receive preferential access. This multiple-RoO world also imposes a significant burden on the customs and origin certifying institutions.

For the Asian countries, the RoO complexity has an important impact on the issue of trade facilitation. Customs clearance in Asia is slow relative to that in Europe and North America. Proliferating FTAs with differing RoO increase the problem. Difficulties arise when the same product may have different countries of origin for customs purposes depending upon the PTA market for which it is destined. For example, a company in Singapore could find that its product can enter ASEAN markets duty-free by satisfying the maximum import content requirement of 60%, but exactly the same product will not be originating in Singapore in the context of the Singapore-Japan Agreement as the latter specifies different origin criteria.<sup>31</sup>

The feature of direct consignment also deserves special mention. The direct consignment rule requires that goods for which preferences are requested, are shipped directly to the destination market, and that if they are in transit through another country then documentary evidence may be requested to show that the goods remained under the supervision of the customs authorities of the country of transit, did not enter the domestic market there, and did not undergo operations other than unloading and reloading. In practice, it may be very difficult to obtain the necessary documentation from foreign customs.

To overcome the complexity of preferential RoO and their related problems, the EU together with the EFTA, Baltic countries and Central and Eastern European Countries (CEECs) introduced a unified system for determining the RoO in 1997, namely, the Pan-European RoO. Brenton (2005) asserts that if such common rules can be designed for Asia, it would facilitate the spread of full cumulation to new agreements, which again would be an important factor allowing for the development of regional production networks. Full cumulation provides for deeper integration and allows for more advanced countries to outsource labour-intensive production stages

to low-wage partners. Full cumulation with simple RoO will make it easier for regionally-based firms to exploit economies of scale that are available.

However, liberalization of the RoO and their poor implementation can lead to trade deflection, defeating the very purpose of the PTA. The RoO implementation is also a serious bone of contention amongst many PTA partners. Improper implementation of these rules may give the origin-certifying agencies opportunities for rent-seeking activities. For example, substantial abuse occurs in the issuance of Certificates of Origin (CoO) in Uganda as a World Bank (2004) study noted. The certifying agencies engage in rent-seeking activities and hence the CoO issued by them are not reliable. Pursuing the veracity of a CoO is a lengthy process and routine verifications exceed the staff resources of the Uganda Revenue Authority. The resulting revenue loss from fraud becomes significant. This is important in the South Asian context as corruption is rampant in most countries in the region.

Also the problem of unscrupulous traders, who give false-invoices to attain the DVA thresholds, has made it easier for circumventing the RoO. Such circumvention is documented in case of copper products from Sri Lanka under the Indo Sri Lanka FTA in Jha (2005), where copper traders in Sri Lanka under-invoiced their imported input prices to circumvent maximum import content required under the Agreement. This has become a major concern for administrative agencies dealing with proper enforcement of the RoO. The case of trade in edible oils between India and Sri Lanka is another example (Box 1). However, there are no enforcement mechanisms to check this. The provisions of ISLFTA are such that they do not provide necessary powers to Indian authorities to challenge the value-addition norms once the Sri Lankan authori-

### Box 1

#### Copper Imports from Sri Lanka to India

"If there is any threat to the Indo-Sri Lankan FTA, it's from the crooked mind – more often than not Indian. Under the FTA, duty concessions can be availed of only when there is at least a 35% value-addition in Sri Lanka. At least 17 unknown Indian companies have set up small furnaces in Sri Lanka to export copper wires to India. These are just processors in the garb of copper producers. And, instead of importing raw materials like copper concentrate or raw copper into Sri Lanka, adding value and exporting to India, these companies import finished products like copper rods or cathodes at zero duty. These are then drawn into copper wires and exported to India.

"What's being imported into Sri Lanka is under-invoiced, resulting in duty loss to India. Often, it is imported at a price even below the one prevailing on the London Metal Exchange. 'Some are importing copper rods in twisted form while declaring them as scrap', says Indian High Commission's minister (economic and commercial) V. Ashok. Import of copper into Sri Lanka has shot up from 7000 tonnes per annum to 54,000 tonnes per annum – perhaps, for re-export to India. In 2003, copper exports were 43% of Sri Lanka's exports to India, up 35% since 2002.

"Even as the two nations grapple with the copper menace, opportunists are readying to launch their assault on another front – vanaspati. At least seven small-time Indian companies have set up shop in Sri Lanka to import crude palm oil, hydrogenate it and export to India as vanaspati. The Indian High Commission has issued orders not to permit vanaspati imports from Sri Lanka. 'At this rate, we will end up breaking the FTA because of the crooked minds of Indians,' says Ashok."

Source: Dubey (2004).

ties clear the consignment. However, this does not mean that the issuer of the CoO is at fault. Value addition norms require lengthy and costly audits to verify the claims of exporters requesting preferences. This is a problem for the developing countries (as in South Asia), which lack the sophisticated accounting systems necessary under this method.

The RoO enforcement, thus, assumes a very important dimension as a policy tool. South Asian trade policy makers should give it more attention as all these countries are not only Members of many PTAs but also plan to enter into many more in future. Bangladesh is planning to enter into an FTA with Pakistan soon, while Pakistan on its part is in various stages of talks with Indonesia, Jordan, Thailand, Malaysia, Singapore, the Gulf Cooperation Council, and Russia for FTA. It also has an operational FTA with Sri Lanka, a PTA with Turkey, and Early Harvest Schemes with China and Malaysia. Sri Lanka has a PTA with Iran and is keen on having an FTA with Bangladesh. India (as is obvious from Table 10.4) has the conclusion of a few more PTAs on its trade agenda. India is also keen on having an FTA with Bangladesh and the Gulf Cooperation Council (GCC). A PTA with the South Africa Customs Union (SACU) is also on the cards. There are joint study groups to assess the feasibility of preferential trade agreements with Malaysia, Indonesia, Korea, Japan, and China. Given all this, let us once more stress that the RoO enforcement will become a very important policy issue for the South Asian countries and the success of all these PTAs in the region will depend on the way RoO are implemented.

Another policy issue for South Asian countries (particularly India) emanating from this study will be to re-look at the design of the RoO and include more supplementary features of the RoO as is done in most PTAs worldwide. But while doing so, it is important not to lose the simplicity of the RoO agreements. Simple, consistent and predictable RoO are likely to be less trade distorting. The criteria for originating products are already very complicated issues in any trade agreement (the Indo-ASEAN CECA negotiations cannot come to force because both the sides are not being able to finalize the RoO for the last three years). Adding more clauses stating exceptions to the general rules agreed upon can increase the complexity of the RoO regime chosen. So even when revising the RoO documents or preparing new documents, the policy focus should be given to make the rules clear and simple.

It is a known fact that the mutual orientation of trade amongst the South Asian countries is quite low (see Annex 2). It is believed that PTAs will augment intra-regional trade. But, as we have seen, the RoO might limit the scope of such intra-regional trade due to their restrictiveness. Nonetheless, it is not possible to do away with these rules as otherwise the problem of trade deflection will surface. Thus they are seen as 'necessary evils'. Given the current stage of development of South Asia, the PTAs involving countries of the region would require relatively strict and systematically implemented RoO. In the absence of a well-defined and properly implemented RoO, the common external tariff of the region would be determined by the most liberal (least tariff) nation of the region. South Asia at its current stage of development cannot perhaps afford to engage in such a competitive race to cut down external tariffs.

## 5. Conclusion

This study was undertaken to explain why the RoO have assumed importance in the context of trade policy and how they affect South Asia. The two variants of the RoO regime (preferential and non-preferential) have been discussed in detail in this paper. After outlining the general effects of the RoO in Section 2, we discussed the two regimes in the context of South Asia in Sections 3 and 4.

The HWP under the WTO, which aims at harmonizing the non-preferential RoO, can have a significant impact on the South Asian region. Nonetheless, even after nearly a decade of intense negotiations, the goal of common RoO continues to be elusive. The central objective of the ARO and also the HWP has been to ensure that the RoO are employed without or with least trade distorting effects. But, as our study shows, it would be optimistic to expect such an outcome from the HWP. In fact, even if it is successfully concluded, the HWP is likely to leave considerable scope for misuse of the RoO for protectionist purposes. The reasons underlying this scepticism are as follows: The preferential RoO, which are more important protectionist tools than the non-preferential rules, are excluded from the HWP. The need for periodic revision of the harmonized RoO, especially in the absence of well-defined procedures for introduction of amendments, leaves scope for misuse of the regime for protectionist purposes. Further, the new multilateral regime, even if it succeeds in establishing a semblance of order in the arena of RoO, is likely to have unequal effects on Members. This is so because even though the harmonized rules are common rules, they differ significantly across product groups. There is no generally accepted norm for deciding what will or will not qualify for substantial transformation and hence origin status. The rigour and stiffness of the test of last substantial transformation, which is also the test for originating status, vary significantly from one product group to other. The rules finally adopted for each product would depend on balance of power between interested parties. Therefore, it is important to examine whether the adopted harmonized rules match the trading interests of the developing nations.

The picture emerging from our analysis of outstanding disputes is not very encouraging for the countries in the South Asian region. The outstanding disputes belong mainly to the traditional areas of western protectionism against the developing countries. For instance, the developed country proposals in textiles and clothing if implemented would be detrimental to the South Asian countries, especially for countries producing upstream products. Similarly, the developed country proposals in the area of tropical products would tend to pre-empt future attempts to establish geographical indications in such products. The message of textiles and clothing underlines the need for more in-depth studies of new RoO proposals pertaining to other important trade areas.

Since the last few years, the phenomenon of preferential RoO came in the picture of the South Asian countries when regionalism spread to this part of the world like others. There are quite a few PTAs (mainly FTAs) in operation and many more are on

the cards. India is the forerunner in the region regarding FTAs. It has fully-operational FTAs with Sri Lanka and Nepal. It is also involved in the regional SAFTA. All these have differing RoO. These differing RoO were analysed along with some other ones found in Indian PTAs with non-South Asian countries/regional blocks. We found the following general features in the RoO of the Indian PTAs:

- The initial Agreements (like ISLFTA) based the RoO on the simple twin criteria (CTC+DVA). Later Agreements invoke all the three rules (CTC+DVA+TECH) and are more complex.
- DVA ranges from 30% to 60% in the Agreements. Cumulation is provided on a bilateral basis (except in India-Nepal FTA) so that DVA requirements are relaxed a little.
- Final manufacturing process is to be carried out in the exporting country only if preferences are to be availed. Also the goods' transportation must obey the direct consignment rule.
- The initial Agreements had simple and clear RoO compared to those which were inked later. This can be understood from the fact that the first Indian FTA (in fact the first of its kind in the region), the ISLFTA, had only five pages of the entire FTA Agreement devoted to the RoO. But the latter ones, especially the India-Singapore CECA, has 54 pages of the RoO, mainly because of detailed product-specific rules, i.e. TECH. Even though the India-Chile or India-MERCOSUR PTAs do not have TECH, they have detailed RoO (approximately 20 pages) with a lot of complex jargon. The regional SAFTA also has 23 pages of detailed RoO. This may be seen as an indication of growing importance of the RoO in the context of preferential trade.

It is seen from an index analysis that the ISLFTA RoO are quite restrictive when compared with the RoO of other PTAs in the world. This means that the provisions that are made in the ISLFTA RoO are more stringent and have the capacity to restrict more trade when compared to other PTAs of the world. The RoO Agreement in ISLFTA does not provide any supplementary rules (other than cumulation) to the main methods of origin determination (like duty drawback, etc). Also, the other PTAs, considered in the index analysis, do not have rigid rules that the last manufacturing process should be carried out in the exporting Member country only.

As all the latter PTAs that India has signed have more complex RoO, we can conclude safely that their restrictiveness will be higher than that of the ISLFTA. Given all this, few policy focus areas, mentioned below, have been identified which assume significance in the context of South Asia:

- Proliferating PTAs with differing RoO complicate trade operations so the issue of trade facilitation should be given more policy focus in South Asia. This is more important given the fact that customs clearance in South Asia is already quite slow. Overlapping PTAs in the region, each having its own set of rules to

determine origin, will impose a greater burden on customs authorities and delay clearances further.

- Producers have to keep track of all the RoO if they want to take the benefit of different PTAs. They might have to keep sophisticated accounting procedures to prove origin in the case of audits or verification by certifying administrative agencies. This may not be feasible for most South Asian producers due to their financial constraints (and this will especially handicap small and medium enterprises in the region to avail the tariff preferences). Also they may face situations where their products will be qualifying as originating in their own country for some PTAs, but in some other PTAs they may be regarded as non-originating due to different RoO. Thus these rules will impose not only additional costs on businesses but may even force them not to avail of the tariff preferences offered by a PTA. Full cumulation of the RoO in the whole region may be one way out of the complexities that differing RoO impose.
- Re-thinking into the design of RoO should be on the agenda for the South Asian governments as they negotiate PTAs in future. More supplementary rules should be incorporated as they relax the stringency of the RoO regimes. However, while doing so, careful consideration must also be given to keep the RoO documents simple and clear as it facilitates easy comprehension and administration.
- That the RoO should be made as simple as possible does not mean that they should be liberalized without taking the present stage of development of the South Asian region into consideration. Too liberal RoO and a poor system of implementation are a sure recipe for trade deflection, and a possible unhealthy race to cut down tariffs.
- Proper enforcement of these rules is also needed to contain activities of unscrupulous traders who may try to circumvent the rules as has been proved in the ISLFTA regarding copper and edible oil trade. So more policy focus should be given to the RoO implementation.

We feel that much more focus needs to be given to the RoO both at the policy level and in further academic research than is presently accorded to the subject. Further focus areas for research could be to examine whether the adopted harmonized rules (under HWP) match the trading interests of the developing nations of South Asia; how the issue of trade facilitation is related to the plethora of RoO conditions that govern South Asian nations' preferential trade now; and to what extent full cumulation of the RoO in the region will help increase trade. More research in the area will generate policy interests and help policy makers to delve deeper into the RoO issue.

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## Annexures

Annexure 1 Rules of Origin (Import Content/DVA) under SAFTA		
Export category	RoO	Cumulative RoO
Products exported from India & Pakistan	Minimum 40% Domestic Value Addition (DVA) in exporting country	Minimum 20% DVA in exporting country provided total regional value addition not less than 50%
Products exported from Sri Lanka	Minimum 35% DVA in exporting country	
Products exported from LDCs	Minimum 30% DVA in exporting country	

Source: From Annex IV of the SAFTA Agreement available at <http://www.saarc-sec.org/main.php>

Annexure 2 Share of intra-region trade among regional block countries as percentage of their total trade			
Region	Intra-region trade as percentage of total trade		
	1981	1990	1998
South Asia	3.2	2.4	4.9
MERCOSUR	10.7	14.0	23.0
ASEAN	15.2	16.3	20.3
EU (15)	55.0	64.5	60.6

Source: Pitigala (2005).