

**Regional Harmonization of Preferential Rules of Origin in Asia:  
In search of a minimum common denominator**

By

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## **I. Introduction**

The multilateral trading system under the WTO faces deepening challenges as more nations enter into regional trading arrangements. As regional trading arrangements derogate from the General Most Favored Nation (MFN) principle under the GATT Article I, international trade is diverted to countries with regional trading agreements (RTAs). Preferential rules of origin accompanying RTAs have exacerbated trade divergence effect because manufacturers source materials from RTA trading partners in order to meet the origin requirements. Moreover, some RTAs engaged in selective liberalization by using restrictive rules of origin, in particular, change in tariff classification (CTC) rules with exception clauses. Preferential rules of origin based on product specific CTC rules without a general criterion for determining the origin for all products tend to favour protection of existing industries in RTA parties, thus exacerbating trade divergence effect.

In this paper, as an alternative to CTC based rules of origin that uses selective market liberalization, we propose that RTAs should adopt a single value-added criterion applicable to all products. A single value added criteria also conforms closely to the economic measure of “substantial transformation”. The general criterion would discourage selective liberalization that exacerbates the negative effects of preferential trading agreements.

To illustrate the practical possibility of a single value-added criterion, the preferential rules of origin adopted in RTAs concluded by the ASEAN including the ASEAN-Japan FTA, the China-ASEAN FTA, and Korea-ASEAN FTA will be examined. Regional trading agreements concluded by ASEAN as a group with East Asian countries illustrate the possibility of regional integration with harmonized and more liberal preferential rules of origin.

Based on the review of ROOs in ASEAN’s FTAs, we suggest the possibility of multilateral harmonization and liberalization of preferential rules of origin. The paper will argue that preferential

rules of origin should be based on the shared principle of “last substantial transformation” criteria, which is converted to a concrete general rule. The path to harmonization of preferential rules of origin lies in using a single regional value content rule with a list of exceptions to the general rule.

In summary, the paper will propose a new strategy of working towards harmonizing the substantial transformation criteria across different products within a RTA as well as across RTAs. As an implementable policy proposal, the paper will argue that RTAs based on the general value-added criteria should be adopted as a concrete step in the direction of fostering multilateral regime of preferential rules of origin. The framework would also enable multilateral rounds of harmonization and liberalization of preferential rules of origin.

## **II. The landscape of rules of origin**

The view of the landscape of preferential rules of origin (ROOs) in regional trading agreements (RTAs) reveals to us a universe of ROOs that appears to be diverging from each other rather than converging to coherent common rules. As preferential ROOs are designed to determine whether an imported product is deemed an originating product of its RTA partner for the purpose of giving preferential tariff treatment, preferential ROOs for a particular RTA reflect the various pressure in favour or against trade liberalization of the product that is evaluated by the ROO. Product specific preferential rules of origin are agreed between RTA parties who treat the rules as an alternative means of market access liberalization. In an ideal world where ROOs serve its stated purpose of determining the nationality of a product, this should not be the case. The observations of RTAs in the world reveal in reality that the landscape of the preferential ROO reflects the clout of the “hub” nations of RTAs.

There are three main RTA hubs in the world: the one in North America with the United States as its center, the European Union and the ASEAN. Each of the RTA hubs is characterized by

distinctive preferential ROOs that each hub more or less consistently maintains with its RTA partners.<sup>2</sup> As a result, an RTA partner which is not a hub country has all three types of ROOs in its FTAs.<sup>3</sup>

All three regimes of preferential rules of origin apply a “wholly obtained” rule for goods produced wholly in a given country and “substantial transformation criterion” for those goods made of materials from two or more countries. The general guidelines for the two principles are provided in the Revised Kyoto Convention<sup>4</sup>, which is applicable to rules of origin adopted by contracting parties including preferential rules of origin. Despite the guidelines, specific implementation of the two principles diverges greatly in preferential ROOs adopted and implemented by signatories of the convention.

In particular, in preferential ROOs adopted in EU’s FTAs called “pan-Euro-Mediterranean” rules of origin, the criteria for substantial transformation is “sufficiently worked or processed”.<sup>5</sup> Only non-originating materials that have undergone sufficient working and processing in the country of export would be deemed originating from the exporting party, thus qualifying for preferential treatment. Product specific rules of origin are defined in terms of the necessary working or processing done on non-originating materials or the threshold value of non-originating materials as a percentage

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<sup>2</sup> WTO Document, Rules of Origin Regimes in Regional Trade Agreements, WT/REG/W/45, at 7.

<sup>3</sup> A good example of a non-hub nation is the Republic of Korea which entered in FTAs with countries with all three different styles of ROOs. The Korea-EFTA FTA contains PANEURO line of ROOs; the Korea-Chile FTA contains the U.S. line of FTAs; the Korea-ASEAN FTA that contains the ASEAN line of ROOs.

<sup>4</sup> The Specific Annex K of the Revised International Convention on the Simplification and Harmonization of Customs procedures (Kyoto Convention) provides certain standards for rules of origin. The Kyoto Convention which entered into force in 1974 was revised and the Revised Kyoto Convention entered into force on February 3, 2006. See WCO Document, Revised Kyoto Convention, “Let’s talk...: Your questions answered”, Feb. 2006, World Customs Organization.

<sup>5</sup> See Article 5, Protocol 4 on Rules of Origin, EEA Agreement.

of the price of the product. A distinctive characteristic of the ROOs in the EU's FTAs is the adoption of a "full cumulation" with the European Economic Association Partner countries and "diagonal cumulation". The EEA Agreement provides a diagonal cumulation under which even products originating from non-parties to the EEA including Turkey and countries which signed the Barcelona Declaration would be considered originating from the EEA area under certain conditions.<sup>6</sup> In general, the EU has adopted common ROO provisions in the EEA agreement and other free trade agreements it has concluded

In contrast to the EU's FTAs, the ROO provisions in the U.S. FTAs tend to have more variations across FTAs. For those goods that are not wholly obtained, a product would be originating if the good satisfies the applicable change in tariff classification or any applicable "regional value content requirement." The regional value content test determines whether a good should be deemed originating good based on the minimum threshold content of the originating material out of the value of the final product. The percentage of the originating material out of the value of a product is either directly calculated or inferred by subtracting non-originating material from the total value.

The third pillar in the landscape of ROO regime can be found in FTAs concluded by the ASEAN. Though the ASEAN is not a customs union, it enters into free trade agreements with other trading nations both in Asia and the rest of the world. However, the ASEAN does not collectively set its external commercial policy. As a result, an individual member nation of the ASEAN grants its own preferential tariff treatments to ASEAN's FTA partners.

The advantage to the ASEAN countries in concluding a FTA collectively with the ASEAN as a group on one side lies in the ROO adopted in the FTA. For example, under the Korea-ASEAN FTA, the accumulation provision in the FTA ROO provides that a product that would normally not meet the criteria for originating good of an individual ASEAN member country would meet the criteria for the

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<sup>6</sup> Article 2.1(b), Protocol 4 on Rules of Origin, the EEA Agreement, provides for "full cumulation" among the EEA parties (EC, Iceland, Norway and Lechtenstein). Article 3, Protocol 4 on Rules of Origin, the EEA Agreement provides for a diagonal cumulation .

originating good if the good is made from materials that are originating in any other member countries of the FTA.<sup>7</sup> A similar accumulation provision is provided in the ASEAN-China FTA as well.<sup>8</sup>

Another feature of the ROO in the FTA entered into with the ASEAN is the use of general Regional Value Content (RVC) criteria. For those products that are not wholly produced or obtained, if the originating materials are not less than 40% of the value of the final product, the product will be deemed originating.<sup>9</sup> The general 40% RVC rule is applicable to all products. In addition to the general rule, goods satisfying product specific criteria would also be considered originating goods<sup>10</sup>; a good can either meet the general criteria or the product specific criteria to be deemed an originating product of the exporting party. The same 40% RVC criteria is adopted in Korea-ASEAN FTA rules of origin.<sup>11</sup>

### **III. Trade distorting effects of rules of origin**

It is well recognized that preferential ROOs can cause trade diversion in addition to the trade diversion occurring as a result of preferential tariff liberalization. As an RTA relationship is established, goods will be purchased from a RTA partner instead of non-RTA countries whose goods will be subject to higher MFN tariffs. As a result, a RTA party will now newly import goods from the

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<sup>7</sup> See Rule 7, Annex 3, the Korea-ASEAN FTA.

<sup>8</sup> See Rule 5, Annex 3, the China-ASEAN FTA.

<sup>9</sup> See Rule 4(a), Annex 3, the Rules of Origin for the ASEAN-China Free Trade Area, the ASEAN-China FTA.

<sup>10</sup> Ibid, Rule 6.

<sup>11</sup> See Rule 4, Annex 3, Rules of Origin, the Korea-ASEAN FTA. The FTA also adopts product specific rules of origin that can also be fulfilled to meet the origin requirement.

other RTA party whereas before the RTA it imported from third countries<sup>12</sup> This trade diversion causes economic inefficiency as more expensive products purchased from a RTA partner.

In addition to the trade diversion caused by preferential tariffs, an accumulation provision included in most preferential ROOs creates another layer of trade diversion. Under a bilateral accumulation provision of a RTA, materials that are originating from a RTA partner would be considered as originating material from its own territory when used in the production of a good for export to its partner. A producer has incentive to purchase materials from its RTA partner instead of purchasing them from third countries.<sup>13</sup> The diversion in material trade causes economic inefficiency because producers would have chosen less costly materials from third countries if it were not for the preferential ROO.<sup>14</sup> A classic example of trade diversion created by preferential ROO is the case of Mexican automobile assemblers who import higher cost components from the U.S. instead of lower-cost third countries in order to qualify for the duty free importation of the final product into the U.S. market.<sup>15</sup> Under the accumulation provision in the NAFTA, the components originating from the U.S. would be deemed to be originating materials from Mexico in determining the origin of the final product. The diversion of intermediate goods is present in every RTAs with bilateral accumulation clause. Though the trade diversion caused by an ROO accumulation provision leads to sub-optimal allocation of goods, it is less “culpable” because the provision is accepted as a standard template with some variations in all RTAs even if the negotiators of a RTA is not using the accumulation clause as a protectionist device.

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<sup>12</sup> See chapter 4, The customs Union Issue, Jacob Viner (new York: Carnegie Endowment for International Peace, 1950), 41-56.

<sup>13</sup> See Anne O. Krueger,

<sup>14</sup> See Anne O. Krueger, 1999, “Free trade Agreements as protectionist Devices: Rules of Origin,” in Trade , Theory and Econometrics, Moore, James, Ray Reizman and James R. Melvin, eds. New York: Routledge, pp. 91-102.

<sup>15</sup> Ibid.

A more systematic distortion results from the existence of divergent preferential ROOs. The criss-crossing bilateral agreements with divergent ROOs connecting various trading partners in the world have been compared to a “spaghetti bowl”.<sup>16</sup> Economic decision makings will be distorted as producers arrange the production process in order to meet specific rules of origin that would permit preferential tariff treatment of the product when the product is exported to its RTA partner. Unless there exists uniform preferential ROOs that are mandatorily adopted by all RTAs, inefficiency caused by the spaghetti bowl effect will persist.

Heterogeneity in preferential ROOs can be attributed to protectionist designs of some ROOs. In many instances where ROOs are used for protectionist purposes, the change in tariff classification (CTC) method with exception clauses is used. The exception clauses stipulated to the CTC criteria prohibits conferring of originating status for certain non-originating materials even if the materials undergo transformation that meets the CTC criteria.

A good example of the use of CTC with exception clause criteria is the product specific rules of origin for ketchup under all FTAs concluded by the U.S. since the NAFTA. Ketchup is classified under subheading 2103.20 of the HS tariff nomenclature. The ROO under the Canada-U.S. FTA provides the chapter change rule that if ketchup is made from any non-originating material belonging to chapters outside of chapter 21, the preferential origin will be granted to the ketchup. In other words, since tomato paste is classified under chapter 20, if imported tomato paste is used to produce tomato ketchup, the resulting ketchup would be conferred origin status.

However, under the U.S. FTAs concluded since the NAFTA, the ROO for ketchup provides that the processing of a non-originating material from any other chapter into ketchup would confer origin except if the non-originating materials fell under subheading 2002.90 (tomato paste). The

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<sup>16</sup> See Testimony by Jagidsh Bhagwati to Subcommittee on Domestic and International Monetary Policy, Trade and Technology, U.S. House of Representatives, Committee on Financial Services, April 1, 2003.

stipulation of the exception clause required the use of tomato pastes originating from FTA parties to produce the tomato ketchup.<sup>17</sup>

Under the ROO for ketchup under the NAFTA, the U.S. ketchup producers would now source tomato paste from either Mexico or Canada whereas under the Canada-U.S. FTA, they were sourcing ketchup from a third country such as Chile. If the purpose of the ROO is to require a higher degree of substantial transformation in the country to confer origin to the product, the value added rule with a higher level of originating material content could have been written. However, an exception clause stipulated in the change in tariff classification rule mandated the use of originating tomato paste, raising the speculation that that Mexican tomato paste industry influenced the negotiation to squeeze Chilean competitors out of the NAFTA market.<sup>18</sup>

Another instance of the use of the exclusion clause in a CTC rule is the product specific ROO for Tunas (HS: 1604.14) including canned tunas in the proposed KORUS FTA.<sup>19</sup> The ROO for canned tunas is a chapter change but excluding CTC from materials of chapter 3. Since tuna fish belongs to chapter 3, imported tuna fish that is canned in the party's territory would not be conferred the origin of the exporting party. Similar instances of using the exclusion clauses under CTC methods are used in ROOs for agricultural products and textile and apparel products.

#### **IV. Harmonization and liberalization of rules of origin**

Divergent preferential ROOs cause economic inefficiency. Even if the rules are not written with protectionist intent, producers bear greater costs to meet the divergent rules in order to receive

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<sup>17</sup> See David Palmetier, Some Inherent Problems with Free Trade Agreements, Law and Policy in International Business, Summer, 1996, at 994-995.

<sup>18</sup> Ibid, at 995.

<sup>19</sup> For products under 1604.14, the product specific rule provides: "A change to subheading 1604.14 from any other chapter, except from chapter 3." See Annex 6-A, Specific Rules of Origin, the KORUS FTA. The U.S. and the Republic of Korea signed the FTA on June 30, 2007.

preferential tariff benefits. The resulting distortion in the manufacturing process leads to less than optimal manufacturing decisions for the producers. Therefore, harmonization of preferential ROO across various RTAs would help minimize the negative effects of criss-crossing RTAs on the world trading system.

However, harmonization of ROOs alone would not cure the inherent trade diversion effect of preferential ROOs. ROOs that require a higher threshold, whether in requiring higher regional content or requiring the use of a certain originating material worsens the trade diversion effect from ROOs because producers will be sourcing materials domestically or from the other sources within RTA parties whereas in the absence of restrictive ROOs materials would be sourced from third parties. Harmonization of ROOs, therefore, must be implemented in conjunction with efforts to reduce the restrictiveness of ROOs.

Scholars as well as policy makers called for multilateral efforts to harmonize preferential rules of origin. The pursuit of harmonizing ROOs faces political challenge of coming up with a rule that can be supported by a critical mass of countries in order to sustain the pursuit. Efforts to harmonize preferential ROO at the multilateral level in the WTO have not born concrete results.<sup>20</sup> Nevertheless, as we have described previously, some degree of harmonization of ROOs has been occurring in RTAs in some regions between hubs and spoke countries.

Setting aside the issues of political feasibility, harmonized preferential ROO should provide consistent rules across different RTAs as well as across different products. For the same product, the ROO should be identical irrespective of RTAs in order to prevent trade diversion from less costly supplier of materials. An identical ROO for the same product between RTAs would also reduce the transaction cost to the producers who does not have to tailor the manufacturing process to meet the ROO of a new RTA partner country. In addition to consistency of ROOs across RTAs, consistency

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<sup>20</sup> Common Declaration with Regard to Preferential Rules of Origin, Annex II, Agreement on Rules of Origin notably does not provide harmonization of preferential rules of origin as its objective.

across different products within a RTA is required. This requirement would assure that the coverage of tariff elimination under a RTA is in conformity with the “substantially all the trade” requirement under GATT Article XXIV:8.

Second, the rule should also conform to the obligations under international treaties regulating preferential rules of origin. In particular, any ROOs should be in conformity with the “last substantial transformation” as provided in the Annex K of the Revised Kyoto Convention. Though the “last substantial transformation” criteria may not be sufficiently concrete and may be inclusive of a wide range of specific rules, it will at a minimum prevent conferring of origin to products that have undergone only “insufficient working or processing”<sup>21</sup> in the exporting country.

Third, the rule should permit future negotiations to further liberalize and harmonize preferential ROOs. The aim is to agree on a general rule for preferential ROOs that a large number of RTAs can adopt. Notwithstanding the general rule, exceptions to the general rule should be permitted to overcome the political challenge of agreeing on a general rule. Any exceptions should be subject to future liberalization and harmonization negotiations.

## **V. Harmonization of rules of origin in Asia**

Harmonization of preferential ROOs should draw its momentum in the existing convergence in ROOs occurring in Asia, in particular in FTAs ASEAN entered into with China and the Republic of Korea respectively. The question is whether the nascent harmonization occurring in Asia has any broader implication for multilateral harmonization of preferential ROOs. In order to answer this question, it is necessary to examine possible reasons behind the convergence of ROOs in FTAs entered into by the ASEAN.

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<sup>21</sup> Preferential ROOs usually define certain transformation of materials to product as insufficient transformation which would disqualify the product from receiving origin status even if the product satisfies all other origin criteria. The EU-Mediterranean ROOs use the term “insufficient working or processing” while the U.S. FTAs defines “non-qualifying operations”.

In essence, the convergence of ASEAN FTAs is achieved through the 40 percent RVC criteria. This general criterion for origin determination is applicable to all products. The 40 percent RVC criteria is also adopted the AFTA, the China-ASEAN FTA, and the Korea-ASEAN FTA. The criteria should satisfy our requirement that the harmonizing ROO should be homogeneous across products as well as across different RTAs.

The RVC 40% criteria first emerged in the AFTA, the free trade area of the ASEAN countries.<sup>22</sup> The emergence of the RVC 40% criterion can be explained by the fact that it is inherently difficult to reach a common ROO between multiple trading partners who are at varying stages of economic development. Instead of negotiating product specific rules for every product, the AFTA adopted a general value-added rule that is applicable to all products. The 40% RVC rule would satisfy “the last substantial transformation” criteria as most product specific rules of origin in other FTAs specify originating value requirement which is close to the RVC 40%. The AFTA ROO did not adopt the list of exceptions from the general rule. In this respect, AFTA ROOs lacks any room for flexibility that is necessary to overcome resistance to harmonization. The AFTA RVC 40% criteria with additional flexibility later became the basis for the general criteria in the China-ASEAN FTA and the Korea-ASEAN FTA.

A significant dilution of the general RVC 40% criteria occurred in the China-ASEAN FTA ROOs. The ROO adopted the RVC 40% criteria but permitted a list of product specific rules of origin which can be satisfied in order for the final product to be treated as originating goods.<sup>23</sup> The product

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<sup>22</sup> See Rule 3, Rules of Origin for the CEPT Scheme for AFTA. The agreement was signed on January 28, 2002. The AFTA members then were Brunei, Indonesia, Malaysia, Singapore, and Thailand.

<sup>23</sup> The China-ASEAN FTA’s rules of origin was agreed by way of the Protocol to Amend the Framework Agreement on Comprehensive Economic Co-operation between the ASEAN and the People’s Republic of China (Protocol). After the conclusion of the Protocol, the negotiation of product specific rules was to commence in January 2004.

specific rules do not replace the general rules. In cases where CTC criteria that is equivalent to the RVC 40% criteria is available, the product specific rules would provide additional option to the exporter. The product specific rules would be trade facilitating because the product specific CTC criteria is less costly for exporters to use. The product specific list would also be a means to reduce the restrictiveness of the RVC 40% criteria if less restrictive criteria can be agreed. The provision of the product specific rules in addition to the general RVC criteria is an improvement over a single general criterion because a medium for future liberalization of the ROOs is built into the agreement.

The Korea-ASEAN FTA ROO afforded a greater degree of flexibility to users of the preferential ROO. The ROO chapter of the Korea-ASEAN FTA also adopted the 40% RVC criteria as a general criterion applicable to all products except for those covered under product specific rules of origin list.<sup>24</sup> In addition, a change in tariff heading (CTH) criteria is optionally provided as a general rule for those products not covered in the exception list.<sup>25</sup> A final product exported to RTA parties can satisfy either the RVC 40% criteria or the CTH criteria whichever results in conferring of origin. In practice, since the administrative cost of determining a change in tariff classification criteria is small compared to that in determining the RVC criteria, exporters will tend to use the CTH criteria as a default choice. If the origin determination is negative under this criteria, then the RVC 40% criteria will be applied to determine the origin of the good.

In the China-ASEAN FTA, product specific rules of origin do not override the general rule. However, the Korea-ASEAN FTA ROO agreement provides for a list of product specific rules of origin that is exclusively applied to those covered in the product specific list.<sup>26</sup> Even if the goods satisfy the general rules, the product specific rules will be controlling rules which must be satisfied in order for the product to be deemed originating products in the exporting party. Therefore, the list of

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<sup>24</sup> See Rule 4.1, Rules of Origin, Annex 3, the Korea-ASEAN FTA.

<sup>25</sup> The CTH criterion requires non-originating materials to undergo the change in tariff classification at four-digit level so that the final product is conferred an originating status.

<sup>26</sup> See Rule 5, Rules of Origin, Annex 3, the Korea-ASEAN FTA.

product specific rules tends to contain more restrictive ROOs than the general RVC 40% or the CTH criteria.

In the Korea-ASEAN FTA, the product specific rules of origin are applicable as alternative rules to the general RVC 40% criteria. Therefore, RTA parties use the product specific rules so as to accommodate the possible domestic protectionist needs if the general rules are considered too liberal.

Comparison Table: ROOs in the ASEAN’s FTAs

<i>ASEAN FTAs</i>	<i>General Value: Value Added</i>	<i>General Criterion: CTC</i>	<i>Product Specific Rules</i>
AFTA	RVC 40%	NA	NA
China-ASEAN	RVC 40%	NA	Alternative PSR
Korea-ASEAN	RVC 40%	CTH	Exception List to General Criteria
<i>Harmonized Rule</i>	<i>RVC 40%</i>	<i>CTH</i>	<i>Minimum Exception List to General Criteria</i>

**VI. Conclusion**

The multilateral trading system can no longer ignore the divergent and criss-crossing ROOs as they pose stumbling blocks to the flow of international trade under the WTO. Efforts to harmonize the preferential ROOs at the multilateral level under the GATT during the Uruguay Round have not resulted in any binding commitments to harmonization and liberalization. Against this background of the failed attempt at the multilateral level to remedy proliferation of divergent ROOs, the world trading system should find lessons from spontaneous emergence of harmonization occurring in Asia.

The FTAs entered into by the ASEAN have been a natural “laboratory” in harmonizing preferential ROOs. In particular, the Korea-ASEAN FTA and the China-ASEAN FTA show promise as a model for harmonization of ROOs beyond the region. The crux of the harmonized preferential

ROO is the general rule that is applicable to all products and across different FTAs. The RVC 40% criteria adopted in FTAs entered into by the ASEAN has emerged as a general rule that meets the above requirements. In addition to the general rule, we advocate adoption of a limited exception list to the general rule in order to overcome the protectionist pressure that inevitably emerges during the process of having the general rule accepted by more RTAs.

In parallel with efforts to harmonize ROOs at the multilateral level under the WTO, at the regional level in Asia, RTAs in the region should make concerted efforts to adopt a general rule applicable to all RTAs that include one or more members the region. Further liberalization and harmonization of divergent preferential rules of origin in the region can be made possible by focusing concerted negotiating efforts to limit and reduce the exception list to the general criteria. The experience accumulated in multilateral liberalization of tariffs in GATT negotiating rounds should be carried over to regional harmonization of preferential rules of origin.