FREE TRADE DOES NOT EQUAL FREEDOM FROM RED TAPE: PRACTITIONER THOUGHTS ON FTAA RULES OF ORIGIN

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Introduction

That "free trade" is at the core of the Free Trade Area of the Americas ("FTAA") is obvious. But the simple phrase "free trade" is deceptive. It conceals such nitty-gritty issues as the meaning of "free" (zero percent duty rates or reduced but not eliminated duties) for a product that "originates" (is considered "made") in one of the FTAA countries. With respect to the latter issue, is a product accorded preferential treatment simply when it is shipped from one FTAA country to another? Or must the product also meet some test for being made in one of the FTAA countries? If there is such a test, how does it work? What does it mean to be *made* somewhere?

This essay considers these questions as it analyzes the proposed FTAA rules of origin—the rules that determine the conditions under which a product[1] is eligible for preferential ("free" trade) treatment.[2] At the time this essay is being written, the third draft text of the international agreement that would establish the FTAA (hereinafter the "FTAA Agreement") is being circulated. In the draft FTAA Agreement, Chapter X concerns the "Origin Regime," and Chapter XI concerns "[Customs] Procedures Related to Rules of Origin." The specific origin rules for actual products, which will appear in an annex to the agreement, have not been publicly released and are the subject of ongoing negotiations. Nevertheless, Chapters X and XI give a clear sense of how the product-specific rules will work. They are being modeled on the origin rules used by the United States, Canada, and Mexico in the North American Free Trade Agreement ("NAFTA"). The NAFTA utilizes a combination of "tariff-shift" and "regional value content" ("RVC") tests to determine when a product is sufficiently "made" in a NAFTA country to be eligible for preferential NAFTA treatment when it is

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[1] The focus is on free trade in products, not services, although the latter are increasingly important in international trade agreements.

[2] A product technically is eligible for preferential treatment if it is an "originating good" pursuant to Article 3 of Chapter X of the draft FTAA Agreement.

traded among the three NAFTA countries.

Part I introduces the basic principles of reciprocity and non-discrimination/discrimination in free-trade agreements. Part II considers, as seen in regional free-trade agreements, rules of origin and, more specifically, the intricacies of tariff-shift and RVC tests. Part III discusses the "red-tape" burdens of origin rules in regional free-trade agreements. The essay concludes with some thoughts on the FTAA Agreement's likely origin rules.

Free Trade, Reciprocity, and Regional Free-Trade Areas

If a country wanted to lower its duty rates for imports from all countries, it would lower its generally applicable duty rates (i.e., the default, baseline rates that apply to products regardless of origin). A true adherent to free trading principles would unilaterally, and without any need for reciprocity by its trading partners, lower or eliminate the duty rates applicable to imports no matter their country of origin.[3] Countries, however, do demand reciprocity from trading partners, and this reciprocity dynamic is at the core, for example, of trade negotiations and agreements of the World Trade Organization ("WTO").[4] The basic notion is a group agreement to lower or eliminate the duty rate for a product by all members of the group.[5] While a true free trader would prefer her country to lower its duty rates even in the absence of reciprocity, most free traders today accept the condition of reciprocity as a necessary evil to produce actual results in free-trade negotiations.[6] Furthermore, reciprocity in the WTO context is also accepted because a country that lowers its duty rate on a product that is "made" in another WTO member country is in effect lowering the duty rate on the product no matter the country of origin because most of the world's countries are now WTO members.

The situation in regional free-trade areas is quite different.[7] A regional free-

[3] *See* Jagdish Bhagwati, Free Trade Today 98 (2002).

[4] The WTO, an international institution established in 1995, was created by a sweeping revision in 1994 of the General Agreement on Tariffs and Trade ("GATT"). The GATT, an international trade treaty, dates to 1947, and over time its administration developed into a quasi-international institution. The so-called Uruguay Round of GATT negotiations concluded in 1994, yielding (among other things) an essentially altogether new GATT—referenced as GATT-1994—and the WTO, a new international institution for the administration of GATT-1994.

[5] The principle of nondiscrimination is at the heart of WTO rules. It requires a WTO Member to accord equal treatment to all other WTO Members (so-called most-favored nation treatment) and to treat equally products that are imported and those that are domestically made (so-called national treatment).

[6] *See* Bhagwati, *supra* note 3, at 102-104.

[7] The "regional" nature of regional free-trade areas includes the obvious situation of countries located contiguously (e.g., in NAFTA) or in a region (e.g., in the FTAA), but it also includes linkages between far-flung countries, such as in the U.S.-Singapore Free Trade Agreement or the E.U.-Mexico Free Trade Agreement. Also, the trade in regional free-trade areas is not always completely "free" of customs duties, because product coverage can be limited and/or duty rates may be reduced but not eliminated. Some commentators thus prefer to utilize the term

trade agreement, such as the NAFTA or the FTAA Agreement, by its nature discriminates against products from outside the region covered by the agreement.[8] There are similarities between free trade in the WTO context and free trade in the context of a regional free-trade agreement: reciprocity is demanded, and agreed-upon duty-rate reductions are accorded to products made in any member of the group. The key difference is that, in the regional free-trade agreement context, the group is relatively small and it necessarily denies preferential treatment to products made outside the regional area.[9] In regional free-trade agreements, therefore, the actual requirements that determine when a product is "made" in one of the regional countries are critically important.[10]

Rules of Origin

Origin determinations concern the complicated matter of what it means to be *made* somewhere. There is a relevant international convention, known as the Kyoto Convention,[11] administered by the World Customs Organization ("WCO"), located in Brussels. The convention includes the concept of goods being "wholly produced or obtained" in a country, but this is essentially restricted to natural-resourced-based products. Most goods are, of course, manufactured goods, and they often contain inputs that are sourced from other

"preferential," and not "free," when referring to regional trade areas or agreements.

[8] Regional free-trade agreements are justified, with respect to trade in products, as being WTO-legal by Article XXIV of GATT and the GATT-1994 Understanding on the Interpretation of Article XXIV, which allow, in certain circumstances, for custom unions and free-trade areas. However, a fairly recent WTO decision, *Turkey-Textiles*, has called into question the legality of many regional free-trade agreements because of their discriminatory nature. *See* WTO Appellate Body Report on Turkey—Restrictions on Imports of Textile and Clothing Products (*Turkey-Textiles*), WT/DS34/AB/R, adopted November 19, 1999 (considering appeal of WTO Panel Report WT/DS34/R, adopted May 31, 1999). *See also* Gabrielle Marceau & Cornelis Reiman, When and How Is a Regional Trade Agreement Compatible with the WTO, LEGAL ISSUES OF ECONOMIC INTEGRATION 28(3) (2001) (suggesting that the *Turkey-Textiles* decision may have created a rebuttable presumption that regional free-trade agreements are GATT-illegal).

[9] A regional free-trade agreement is but one ideal type of regional economic integration. Lesser integration is associated with a preferential-trade agreement, *supra* note 7, whereas increasingly greater integration is associated with customs unions, common markets, economic unions, and finally economic and monetary unions. *See* BERNARD HOEKMAN & MICHEL KOSTECKI, THE POLITICAL ECONOMY OF THE WORLD TRADING SYSTEM 213 (1995).

[10] Rules of origin are also employed for other purposes, such as when determining the origin of an imported product that must be labeled with a "country-of-origin marking." *See, e.g.*, 19 U.S.C. § 1304 and 19 C.F.R. Part 134 (setting forth the general requirements concerning a country-of-origin marking for articles imported into the United States). *See also* David Palmeter, *Rules of Origin in Customs Unions and Free Trade Areas*, in REGIONAL INTEGRATION AND THE GLOBAL TRADING SYSTEM 327 (Kym Anderson & Richard Blackhurst eds., 1993) (noting as well the use of origin rules in the administration of country-specific import quotas).

[11] The Kyoto Convention is formally known as the International Convention on the Simplification and Harmonization of Customs Procedures (in force September 25, 1974). *See generally*, David A. Pawlak, *Learning from Computers: The Future of the Free Trade Area of the Americas*, 27 U. MIAMI INTER-AM. L. REV. 107, 134 (1995) (hereinafter Pawlak, Computers); Marianna C. Silveira, *Rules of Origin in International Trade Treaties: Towards the FTAA*, 14 ARIZ. J. INT'L & COMP. L. 411, 420 (1997). A revised, updated Kyoto Convention has been negotiated but has yet to enter into force.

countries. Therefore, origin is attributable to the last country where significant manufacturing or processing operations create a good. The test looks for the place where the last "substantial transformation" occurs, with "substantial" meaning sufficient to give a final good its "essential character."

Substantial transformation is a slippery concept and is hard to apply in practice.[12] The Kyoto Convention simply mentions permissible criteria for determining substantial transformation: changes in tariff classification; specific, listed operations which do or do not result in substantial transformation; the relative value of materials, by their origin, in a final good; or the value added in the exporting country.[13]

In a regional free-trade agreement, the simplest way to confer origin is to base it upon the country from which a product is imported. Under this approach, if a product is shipped from, say, Mexico to the United States, it is "Mexican." This approach, of course, undermines discrimination against extra-regional products because such a product can become eligible for preferential treatment by simple trans-shipment through a regional country.[14] At the other extreme, another approach would require, for a product to be "made" in the region, that all of a product's components be ultimately derived from the natural resources of the region and that all manufacturing operations that produce the components and the final product be in the region. Given pervasive international sourcing of

[12] *See* Palmeter, *supra* note 10, at 328-29 (noting criticism of the "substantial transformation system" as being "inherently imprecise and subjective").

[13] *See generally*, Hoekman & Kostecki, *supra* note 9, at 102; Palmeter, *supra* note 10, at 335. GATT-1994 includes an Agreement on Rules of Origin, but this does not apply to rules of origin in regional free-trade agreements. *See* Hoekman & Kostecki at 102-104. *See generally*, Pawlak, Computers, *supra* note 11, at 137-39; Silveira, *supra* note 11, at 436-39. At least one commentator suggests that the WTO origin rules being developed pursuant to the Agreement on Rules of Origin, which apply to origin determinations related to *non-preferential* concerns, will likely be the basis for future WTO origin rules that concern preferential free-trade areas. *See* Silveira, *supra* note 11, at 438. This assumes that the WTO can even develop specific origin rules for non-preferential purposes pursuant to the Agreement on Rules of Origin, and progress in this area has bogged down. *See* Lan Cao, *Corporate and Product Identity in the Postnational Economy: Rethinking U.S. Trade Laws*, 90 CAL. L. REV. 401, 474 (2002) ("Current efforts by a WTO committee to harmonize rules of origin in the Agreement on Rules of Origin remain unresolved because of disagreements about which types of activities qualify as origin conferring.").

[14] *See* David A. Pawlak, *International Trade in the Americas: The Inter-American Lawyer's Guide to Origin Determinations*, 5 TUL. J. INT'L & COMP. L. 317, 327 (1997) (hereinafter Pawlak, Lawyer's Guide) ("This practice is termed trade deflection or transshipment. Rules of origin make it difficult for traders to use transshipment to cloak their nonoriginating goods with bogus originating status in a surreptitious attempt to gain FTA preferential tariff treatment."). This approach is rarely utilized. However, it is the approach taken, with respect to a limited number of products, in the "Integrated Sourcing Initiative" of the United States-Singapore Free Trade Agreement. *See* U.S.-Singapore FTA, Article 3.2 and Annex 3B. This has been controversial because, among other reasons, it effectively allows for free trade with a third country without certain commitments concerning labor and environmental protection that could be required as part of a free-trade agreement with that third country. *See* Sandra Polaski, Serious Flaw in U.S.-Singapore Trade Agreement Must Be Addressed, Issue Brief, Trade, Equity, and Development Project, Carnegie Endowment for International Peace (April 2003) (criticizing the U.S.-Singapore FTA approach as a loophole for free trade in Indonesian products without any commitment by Indonesia for minimum standards for and enforcement of labor and environmental protections).

components for manufactured goods, this approach is overly restrictive. In a regional trade agreement, therefore, the compromise is an allowance for extra-regional inputs so long as the manufacturing operations that do occur in the region, in the creation of a product, are substantial. It currently appears that the test for substantiality that will be utilized in the FTAA Agreement is based on the NAFTA model, which requires a "tariff shift" by the extra-regional components and/or a minimum regional value content ("RVC") with respect to the final product.

To understand a tariff-shift requirement demands an understanding of the basics of tariff classification.[15] A country's tariff schedule is a system of classifying products into groupings. The groupings start broadly and narrow, with subsets and subsets of subsets, until one arrives at the classification. Through work centered at the WCO in Brussels, many countries have adopted the same standard nomenclature and taxonomy, to a certain level of depth, in their tariff schedules, and this harmonization (among other things) facilitates the use of tariff shifts in origin tests.

When classifying a product in a tariff schedule, one starts with the broadest groupings, called headings, decides which one is correct (only one can be correct), and then works down within that chosen heading to determine the appropriate subheading and the ultimate full classification (sometimes called the "item number," "item code," or "tariff item").

The employment of a hypothetical example is useful. Let us consider a hardbound book that consists simply of a hard cover, made of cardboard; paper; and printing ink. In our hypothetical tariff schedule a book is fully classified in a provision that identifies "hardbound books" by name. This classification is within a subheading of products termed "books and other printed matter," which itself is a subset of a heading that covers "miscellaneous articles." For the hardbound book to "originate" (be made) in Country X for the purposes of a regional free-trade agreement, let us require that its components either be from Country X or, *with respect to foreign-made components*, that they undergo a shift in tariff classification, as a result of the creation of the hardbound book in Country X, such that their classification shifts from outside to inside the heading of "miscellaneous articles" (where the hardbound book is classified).

Application of this test requires a determination of the classification of the foreign-made components. Assume that the paper is classified in a provision that covers "paper for books" that is within a heading of "paper and articles of paper," and let us say that the printing ink is classified in a provision covering "printing ink" that is itself within a heading for "dyes, pigments, paints, and inks." When these components are transformed from individual pieces of paper and printing ink into the hardbound book, they successfully shift in tariff

[15] The tariff classification of a product, along with its country of origin, is used to determine the applicable duty rate.

classification from outside to inside the heading "miscellaneous articles," which covers the hardbound book. Therefore, it does not matter if the paper and printing ink are themselves from outside Country X, because their processing (into a hardbound book) in Country X transforms them, according to the tariff-shift test, into a product of Country X.

The remaining component is the hard cover. If the cover itself is classified in the tariff schedule somewhere within the heading "miscellaneous articles," the hardbound book will fail the tariff-shift test because the cover's classification will then begin and end in the same heading, "miscellaneous articles." In this situation, for the hardbound book to originate within the regional free-trade area, the cover would need to be made in the region. On the other hand, if the cover is classified elsewhere in another heading—within, maybe, "articles of cardboard"—the hardbound book will fully satisfy the tariff-shift test.

There are numerous problems with a tariff-shift test. First, one can easily come across situations where there is hardly any real change in components in the creation of a final product but the test is satisfied simply because of the peculiarities of how the final product and its components are grouped in the tariff schedule. Second, while many countries now share, to a substantial but incomplete degree, a common tariff schedule, the actual classification of the same item may differ between countries. Two countries, sharing a harmonized tariff schedule, may come to inconsistent conclusions regarding the proper classification of the same item, especially when there are multiple classifications, which arguably include the item. The devil, so to speak, is in the application of the otherwise harmonized nomenclature and taxonomy. The uncertainty and inconsistency that characterizes tariff classification can lead to difficulties associated with a product's eligibility for preferential treatment under a regional free-trade agreement. If countries in a regional free-trade agreement have different opinions on the tariff classification of components of a finished product, they may very well have different conclusions for whether the finished product meets an origin rule if it is based on a tariff-shift test.

The shortcomings of tariff-shift tests appear likely to force the FTAA countries into substitution or supplementation with RVC tests. The basic notion behind an RVC requirement is that eligibility should be conferred only if a certain minimum amount of the final product's value is attributable to the region. The main RVC test, at least the main formulation used in the NAFTA, employs the "transaction value" method.[16] This requires that a minimum of 60 percent of a final product's value, determined by its import sales price, be attributable to the region. The simplest way of calculating RVC is to add the value of all extra-regional components and then take the sum and express it as a percentage of the final product's value. If it is no more than 40 percent, the final product satisfies

[16] There is also a "net-cost" method that employs a bottom-up approach of adding certain of the costs associated with making a final product.

the test.[17]

This simple explanation of an RVC test conceals many complications in actual practice.[18] To establish RVC for a final product one must have a costed bill of materials for the product. With respect to the cost of each extra-regional component, there must be documentation to substantiate that cost. For example, if the component was purchased, there must be proof of the purchase (e.g., a purchase order and subsequent invoice) and of the price paid (e.g., payment records); and the allocation of that cost (price) must be documented if it is not expressed in terms of unit prices.[19] Finally, with respect to each regional component, there must be documentation to substantiate that it indeed originates within the region.

Red Tape, or Is This Really Free Trade?

Once one has a grasp of even just the basics of the complicated nature of origin rules and their application, it is not difficult to recognize that free trade comes at the cost of increased red tape.[20] For practitioners of international trade it is common to work with clients who are truly shocked to learn of all the hoops through which they must jump in order for them or their customers to take advantage of much-publicized "free trade." The problem is multiplied when a country enters into many regional free-trade agreements and each of those agreements has its own and, to some extent unique, origin rules.[21]

An interesting twist on the burdensome nature of origin rules is that the burden of compliance often falls on exporters, not importers. Importers take advantage of preferences (zero or much-reduced duty rates) under regional free-

[17] If the extra-regional components collectively comprise 40.1 percent or more of the final product's value, the product will fail the RVC test because it will then have an RVC of 59.9 percent or less.

[18] "Whatever else value-added as a rule of origin may be, certain and efficient it is not." Palmeter, *supra* note 10, at 332.

[19] The aforementioned net-cost method, supra note 16, is an especially burdensome exercise in cost accounting. *See generally*, Pawlak, Lawyer's Guide, *supra* note 14, at 346 ("[R]egional value content tests require complicated and costly bookkeeping, as well as subjective interpretations regarding what costs of production may be included in the value content calculation.").

[20] *See* Cao, *supra* note 13, at 469 ("[T]hese highly complex [origin] rules and the equally complex customs regulations implementing them may also be a form of nontariff barrier impeding duty-free trade." (footnote omitted)). An analysis of one regional free-trade agreement found the compliance burden to equal "at least 3 per cent of the value of the goods concerned" and to be sufficient to "lead exporters of up to 25 per cent of presumably eligible trade to forgo the preference and simply pay the normal duty." Palmeter, *supra* note 10, at 332.

[21] Indeed, Jagdish Bhagwati points to a "systemic problem posed by an explosive proliferation of" regional free-trade agreements. Bhagwati employs a "spaghetti bowl" metaphor, arguing that the situation has turned "into a "spaghetti bowl:" a messy maze of preferences as [regional free-trade agreements are] formed between two countries, with each having bilaterals with other and different countries, the latter in turn bonding with yet others, each in turn having different rules of origin (as required by the preferences sought to be given and taken, without "leaks" to nonmembers via entry into members) for different sectors, and so on." Bhagwati, *supra* note 3, at 112-13.

trade agreements. Importers are generally required to request and then maintain some sort of certification from the exporter of the product. In such a certification the exporter states that the product is eligible for preferential treatment under the applicable origin rule. It is up to an exporter in one of the region's countries, therefore, to grapple with the complexities and record keeping burdens of tariff-shift and RVC tests. Market forces generally compel exporters to suffer these burdens because their customers, in other countries in the free-trade region, demand certifications so they may import the exporter's product at the free or reduced preferential duty rate.

The government of the country of importation may, of course, dispute the eligibility of an imported product under the applicable origin rule. Sometimes officials from the customs authority of the importing country audit the exporter's certification, checking the analysis and supporting documentation of the exporter. It is during these audits that disputes over classification of the final product or its components (in tariff-shift tests) or over accounting issues (in RVC tests) come to the fore. When, for whatever reason, an importing country denies eligibility to a product that has been imported with a claim of eligibility in the past, it is the exporter's certifications of eligibility that are invalidated. At this point, the burden of eligibility compliance—or more correctly, of non-compliance—shifts to the importer, who can face a demand for back duties and interest, which can amount to huge sums. An importer in such a situation often in turn demands that it be indemnified by the exporter because it was the exporter's faulty certification that caused the problem. It is understandable that, at this point, the importer and exporter are likely to have lost all enthusiasm for regional free-trade agreements; and they certainly would have been disabused of any notion that this sort of "free" trade has anything to do with the truly unburdened flow of goods.

Conclusion

The foregoing discussion highlights the reality that regional free-trade agreements are not about international trade that is unencumbered by customs duties or red tape. The proposed FTAA Agreement appears headed toward rules of origin modeled after those of NAFTA, which, with a mix of tariff-shift and RVC tests, are complicated and burdensome. One solution is the reduction of general duty rates that apply regardless of an imported product's country of origin, but this is exactly what is not happening as multilateral negotiations at the WTO continue to stall.[22] On the other hand, more regional free-trade agreements, including the FTAA Agreement, appear likely to enter into force, which makes an understanding of rules of origin critical for a true understanding of the nature of today's, and likely tomorrow's, "free" trade.

[22] The current negotiations, the first since the Uruguay Round created GATT-1994, are referred to as the Doha Round.