

DRAFT: May 15, 2003

US Trade Politics and Rules of Origin:
Notes Toward A Paper

Prepared for Presentation to
Workshop on Rules of Origin
Paris, France
May 24, 2003

I. M. (Mac) Destler
School of Public Affairs
University of Maryland
and
Institute for International Economics

Rules of origin are regulations, often quite detailed, that determine which products (and hence, which producers) will gain the benefits of discriminatory trade agreements. Because they affect who gets what, when, and how,¹ they are intrinsically political. Because they are often detailed and technical, this politics tends to be asymmetric: those who benefit directly are deeply engaged, while others affected only marginally tend to stay on the sidelines. Hence they can exhibit, in accentuated form, the political imbalance that can tilt overall trade policy toward restrictiveness and against the maximization of national welfare.²

Rules of origin (ROAs) are made necessary, of course, by trade policies that discriminate among supplier nations. In a pure MFN (aka NTR) world, where a product comes from is of no consequence, except for the compilation of trade statistics. Those who move it across a national border must pay the same required tariff to the importing country, and once it crosses that border

¹This is the classic definition by Harold D. Lasswell and the title of his book: *Politics: Who Gets What, When and How*. A recent publisher is Peter Smith (January 1990).

²See Destler, *American Trade Politics* (Institute for International Economics and Twentieth Century Fund, 3rd edition, 1995), pp. 4ff.

it is treated, in most respects, identically with those produce within that importing country. But though MFN remains the governing rule for most trade, there are important exceptions. Two in particular deserve our attention.

One, presumably diminishing in importance, arises from the implementation of country-specific export restraint or quota agreements, such as those that proliferated under the Multi-Fiber Arrangement (MFA) of 1973 and its successors. If Hong Kong is allowed to sell the United States X number of men's shirts, for example, and does not fill the quota for economic reasons, its exporters are not allowed to make up the shortfall with shirts produced on the Chinese mainland. But they have a strong incentive to do so, or to undertake token reprocessing in Hong Kong. US textile and apparel producers have regularly denounced such circumvention, of course, insisted on rules to prevent it, and urged tighter monitoring and enforcement of these country-of-origin requirements. But with the scheduled phase-out of the MFA at the end of 2004, the incidence and importance of this source of ROAs can be expected to diminish.

By contrast, free trade agreements (FTAs), the second major source of ROAs, are clearly on the increase. If two or more countries agree to eliminate barriers on trade within their group, but still maintain their own varied schedules of restrictions against imports from countries outside the group, they risk circumvention: exporters will move a product into the nation with the lowest tariff, for example, and then trans-ship it across the now-duty-free boundary to a higher-tariff group member. The FTA member nations could avoid the need for ROAs, of course, if they took the next step and established a customs union with common external trade barriers, as provided in Europe's Treaty of Rome.³ But assuming they do not, and most do not, they need rules to prevent outside producers going around members' higher tariff rates.

It is this second driver of ROAs that is the focus of this paper and, apparently, this workshop.

And it is made interesting by the globalization of production. If a product is crafted entirely within one country, then the identity of that country determines whether or not the product gets

³If one takes the term literally, they would still have a rule of origin, but the simplest possible one: products entering from outside pay tariffs; those crossing national borders inside do not.

into an FTA member country duty-free. But the product may in fact be multinational its main raw material from country A, its locus of final assembly in country B, with inputs brought in from countries C and D, etc. Again, a simple rule would be to define its origin by where it is assembled. But for some products, the value added in the final assembly process is small. In fact, a firm could build a sort of sham factory in an FTA-member country that would simply join two elsewhere-constructed parts together, a process adding minuscule value to the final product but enabling it to benefit from duty-free treatment when shipped to another FTA member.

So if the benefits to FTA members are to be preserved, we need a rule, or rules, distinguishing goods that receive favored status from those that do not. We need to have a way to know what is a North American product, to take the largest and most successful of the new generation of FTAs. How much value must be added within the free trade area for it to qualify? Or what manufacturing processes must it undergo? The basic rule could be very simple: in the Canada-US Free Trade Agreement, for example, an automobile could be shipped duty-free across the border if 50 percent or more of its value was generated within the two member countries. If not, not. This would seem to be a reasonable, even Solomonic, general rule. Why not simply apply it across the board and be done with it?

The answer, of course, is that rules matter a great deal to competing producers. Those within the contracting nations wish to maximize the degree to which they benefit from the agreement at the expense of competitors particularly those based outside of the FTA. In the case of autos, US manufacturers thought the Canada agreement standard insufficient for their fierce international competitive battle. As Frederick W. Mayer describes it,

All three automakers had an interest in a reasonably high rule of origin to make it more difficult for European and Japanese competitors to locate assembly plants in Canada or Mexico and thereby ship finished automobiles to the United States duty free. But GM differed from Ford and Chrysler. . . .Because of [its] joint venture with Izuzu in Canada, GM favored a lower rule of origin, around 60 percent. For reasons that reflected their own patterns of production and competitive position, Ford and Chrysler preferred a higher rule, approximately 70 percent. Autoparts makers had every incentive to push for as high a percentage as possible, since high percentages protected them from foreign competition.⁴

Canada and Mexico preferred a number closer to the 50 percent of Canada-US, to accommodate Japanese and European transplant producers within their borders.⁵ In the end, agreement was reached on 62.5 percent, reflecting the particular strength of the US Big Three automakers. As Mayer notes in his analysis, In this bargain. . .the negotiation begins to look less like a deal among three nations than a deal among a collection of private interests, many of whom span national borders. ⁶

Autos was the largest industry involved, and the stakes in 1991-92 were perceived as particularly high, given the then-apparent success of Japanese manufacturers at Big Three expense. But it was far from the only industry with its own tailored rules. Annex 401 to the North American Free Trade Agreement contains 150 pages of specific rules of origin divided into twenty sections (and 97 chapters), from live animals to mineral products to wood and articles of wood to textile and textile articles, to name but a few.

⁴Frederick W. Mayer, *Interpreting NAFTA: The Science and Art of Political Analysis* (Columbia University Press, 1998), pp. 157-58.

⁵The numbers are not strictly comparable, as NAFTA employed a method of calculation different from that in the bilateral pact.

⁶Mayer, p. 162.

The basic ROA on textiles was particularly ingenious. At its core was the triple transformation test, which required that for a piece of apparel to be treated as a North American product, it had to go through three basic processes: the making of fiber, then cloth, then clothing within the NAFTA region. Since clothing made in Mexico would avoid both MFA quotas and the relatively high US tariffs, it was likely to substantially displace, in the US market, imports from East Asia. If that clothing used NAFTA-made fiber and fabric, US mills stood to gain enormously, since they had comparative advantage on textile production within the FTA.

Critics protested, of course, that this was hardly free trade. Rather, it was in their eyes an egregious trade distortion. Columnist George Will suggested that a true free trade agreement would consume two or three pages, not two thousand. Scholars like Richard Cooper argued, furthermore, that ROAs generally offered an egregious opportunity for rent-seeking by special interests. They are detailed and technical, hence hard for trade generalists to understand. They are a juicy invitation to partisan lobbying.⁷ With the goal of putting some limits on such perceived abuses, his Harvard colleague Robert Z. Lawrence has suggested, citing Richard H. Snape, that there should be a single rule for all products: the use of sector-specific rules of origin should be illegal in free trade areas.⁸

The critics are obviously right in their diagnosis: ROAs and their crafting are fair game for protectionists, or (if one dislikes this application of that pejorative label) those wanting to

⁷Remarks at Conference on Free Trade Areas, Institute for International Economics, Washington, D. C., May 7, 2003.

⁸Robert Z. Lawrence citing Richard H. Snape, "Regionalism and the WTO: Should the Rules Be Changed?" in Jeffrey J. Schott, editor, *The World Trading System: Challenges Ahead* (Institute for International Economics, 1996), p. 51.

manipulate the rules in their favor. They are similar in this respect to antidumping laws and regulations, which most economists and many trade experts also abhor. And like the so-called unfair trade statutes, they have also imposed their normative vocabulary on the debate. They have legitimacy because, in their basic form, they address a clear apparent problem of enforcing the rules of an FTA. Just as critics of skewed dumping rules risk can be charged with wanting to weaken our protections against unfair trade,⁹ those who oppose restrictive rules of origin can be accused of advocating circumvention of the agreement by producers in non-member states. ROAs surely offer political cover for some outrageous specifics. Yet often their advocates can also claim the high moral ground.

There is, however, a more fundamental reason why producers are allowed even encouraged to write the rules of origin for their product areas. Their support is often needed for an FTA to become law. So the suggested remedy outlawing industry-specific rules could prove worse than the disease.

The author of this essay is only one of many scholars to see the root problem of trade politics as the imbalance in trade-political engagement between those favoring protection and those seeking to open markets.¹⁰ Particularized benefits tend to trump the general welfare in the political arena. And the near certainty of a loss from market-opening generates action much

⁹Research that I conducted jointly with John S. Odell and Kimberly Ann Elliott found that there was less resistance to trade protection in cases where it came in the context of charges of unfairness and enforcement of the anti-dumping laws. The normative framing of the issue seems to matter. See *Anti-Protection: Changing Forces in United States Trade Politics* (Institute for International Economics, Policy Analysis No. 21, 1987), pp. 73-74.

¹⁰Prominent works highlighting this imbalance in differing ways include E. E. Schattschneider, *Politics, Pressures and the Tariff* (New York, Prentice-Hall, 1935) and Mancur Olson, *The Rise and Decline of Nations* (Yale University Press, 1982).

more than the general potential of gains for pro-trade interests like exporters or import-users. Therefore, free trade typically needs political help. A NAFTA (or a future FTAA) needs support to counter the clear losers, and broadly distributed gains from free trade are typically not enough to generate that support. So those seeking a pro-FTA coalition need concrete means to make key economic interests believe that the agreement will make them clear winners.

Kenneth A. Oye makes the general point well. Writing at a time when discriminatory trade arrangements were increasing and the global, GATT-based MFN trade regime appeared to be weakening, he argued that the negotiating of discriminatory agreements could have, and has had, liberalizing effects by providing export-oriented sectors with a narrow interest in campaigns against protection of import-competing sectors.¹¹ More generally, such particularized agreements contributed to a more open national and global economy by giving particularized benefits to interests that were therefore given a direct stake in trade expansion even though the agreements inevitably created trade diversion as well.

Oye does not give special attention to rules of origin. Yet his argument can easily be extended to them. ROAs can be drafted to assure economic interests that they *will* gain from the trade expansion that the FTA will foster. The specific language helps determine *how much* these interests will gain. And their participation in the drafting can bring them on board a coalition in support.

For an illustration of just how important they can be, let us return to the case of NAFTA and automobiles. Recall the situation of the US Big Three in 1991-92. Despite major

¹¹Kenneth A. Oye, *Economic Discrimination and Political Exchange: World Political Economy in the 1930s and 1980s* (Princeton University Press, 1992), p. 170.

restructuring in the 1980s, and several years of protection from voluntary Japanese export restraint, US manufacturers were still viewed as losers in the market battle with their trans-Pacific adversaries. And they acted like they saw themselves that way. Their plight was symbolized, albeit exaggerated, by President George H.W. Bush's ill-fated trip to Tokyo accompanied by the Big Three executives, with the United States seeming to be deploying political strength to offset market weakness.

But the automakers' orientation remained central to US trade politics. A NAFTA that they opposed would not have been politically viable. They knew this, and the Bush administration did also.

So on auto rules of origin, the US position in the trilateral talks was in essence the industry position. As Mayer illustrates in detail, an effort to accommodate the various preferences of the auto and auto parts producers led to a goal of a 65 percent rule (bargained down to 62.5 percent at the eleventh hour by Mexico and Canada).¹² And the auto industry joined the broad coalition of supporters that turned the political tide in the fall of 1993.

Textiles is an even more interesting story. For more than half a century, the politically potent mills, concentrated in the states of North and South Carolina, had aligned themselves with the geographically dispersed US apparel makers to win broad and oft-growing trade protection, over a period when most other import-impacted industries were losing theirs. The economic logic was simple: the US apparel industry was the main market for the mills' cloth. Employing a

¹²Mayer, *Interpreting NAFTA*, pp. 155-62. The position of the United Auto Workers, who wanted a higher percentage, was not taken seriously because they were not expected to support NAFTA in any case.

full panoply of political resources, the textile industry got administrations from Eisenhower onward to negotiate a broad regime of quotas, first on cotton cloth and products, then on synthetics and wool products as well. Between 1985 and 1990, they also succeeded in getting Congress to pass, on three separate occasions, bills that would have embedded such quotas in US law, in gross violation of the nation's GATT commitments.¹³

But they couldn't get enough House votes to override any of the anticipated three Presidential vetoes. And their negotiated protection was proving leaky: imports rose substantially, particularly in the 1980s, and particularly of labor-intensive apparel products. So after pushing for quota legislation beyond the time when it had any chance of enactment, the textile manufacturers reviewed their position. The Uruguay Round negotiations were pointing clearly towards an MFA phase-out, so fewer and fewer domestic apparel firms were likely to survive to use the American mills' fiber and fabric. So the textile industry shifted its stance: if a growing share of clothing sold in the United States was to be imported, they would look for ways to have that imported clothing made with US cloth.

So they jettisoned their decades-old domestic apparel allies. They could live with NAFTA with the likely flood of apparel imports from lower-wage Mexico if North American clothing had to be made with North American cloth.

For USTR negotiators knowing that NAFTA was politically controversial and looking to broaden NAFTA's support, this was an offer they could not refuse. So the mills got their triple transformation test. And NAFTA got Carolina votes. In the 1991 vote extending fast-track rules

¹³*American Trade Politics*, esp. pp. 187-88.

that was a *de facto* authorization of the NAFTA negotiations, Representatives from North Carolina had voted 9-2 in the negative. But this was before the rules of origin we negotiated. Once the triple transformation test was embedded in the treaty, and it came before the House for its dramatic final vote in 1993, legislators from that state shifted to 8-4 in favor.

Of course, the textile firms did not rest on their laurels, but worked to enact rules that required dyeing of the cloth in the region as well. An opportunity came in December 2001, when Republican leaders—having alienated many swing Democrats—were desperate for votes to pass President George W. Bush's fast-track bill—now known as Trade Promotion Authority, or TPA. A textile Congressman who normally opposed trade-expanding legislation was available provided the President would promise to get the rules for Andean nations' trade preferences revised to include the dyeing requirement. The promise was made, the vote was switched, and the gavel came down, locking in the 215-214 margin.

Concluding Thoughts

For free-traders, restrictive rules of origin—like antidumping laws—represent a sort of pact with the devil. They seem politically necessary in the short run, pernicious in the longer run. Can one play with the devil but sustain the upper hand? The long experience with textiles in general suggests that the answer can be yes: protection for that industry eased enactment of generations of liberalizing legislation, and in the end it was textile protection that eroded, not market-opening trade policy.

But the problem is to yield only what one has to, and recoup when one can. The aim of the particularized interests, by contrast, will be to pocket what they have and go for more: to

tighten rules of origin, to close loopholes, to broaden definitions to their advantage just as some have done persistently with the anti-dumping laws. The House vote of 2001 is a case in point.

How can one limit such concessions. In principle, the obvious domestic remedy is to broaden support for open trade. Textile people had leverage in the NAFTA negotiations because the ratification vote was expected to be excruciatingly close. They had leverage in 2001 because the TPA vote *was* close. And it was close because other potential sources of support had been alienated, particularly on-the-fence Democrats. So the way to contain restrictive rules of origin is the same way to avoid an FTAA being hostage to the Florida orange growers: by broadening the base of support. This means, among other things, responsiveness to social issues Democrats care about, effective implementation of newly expanded trade adjustment programs for workers, and engaging now-minority Democrats in the House legislative process on trade, rather than circumventing them as was the Republican strategy in 2001.

One might also imagine other devices to modify pernicious rules: like a sunset or review provision for ROAs, requiring their reanalysis and redrafting every 5 to 10 years. If the agreement itself did not hang in the balance, industry leverage would not be so great.

If one were willing to sacrifice or limit the political benefits of ROAs in buying support for trade agreements, in order to curb their costs, there might be new international institutional rules:

Outlaw FTAs unless they are also customs unions?. This would eliminate ROAs by outlawing the agreement structure that gives rise to them. But this would require some capacity for FTA member nations to act jointly to set, and oversee

implementation of, common external barriers. Members might not be willing to endorse such supra-nationality.

WTO review under Article 24? This provision of the GATT sets loose guidelines for FTAs. It has never been effectively enforced, but specific ROAs could be challenged:

- 1) Under its general rule that FTA should not raise barriers to the trade of other [WTO] members. ¹⁴
- 2) With the adoption of specific ROA guidelines: i.e., the Lawrence-Snape suggestion that Article 24 be amended to allow [just] one rule for all products, such as a certain percentage of value added. ¹⁵

Surely the most effective way to mute the impact of restrictive rules of origin, however, is to reduce the value of the FTA itself by negotiating down the level of trade barriers imposed on the world at large. The auto ROAs in NAFTA were important symbolically and politically, but their actual economic impact was marginal. When the CEO of the Ford Motor Company expressed outrage that United States agreed to 62.5 instead of 65 percent, chief US negotiator Jules Katz reminded him, We re talking about a 2.5 percent difference on a 2.5 percent tariff. ¹⁶

¹⁴Lawrence, p. 51.

¹⁵*Ibid*, p. 52.

¹⁶Quoted in Mayer, *Interpreting NAFTA*, p. 143.