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# Rules of Origin and US trade policy

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Traditional, autarkic, producer-based protectionism has long been declining in the United States, and is now weaker than at any time since Alexander Hamilton's *Report on Manufactures*.<sup>1</sup> But the same globalization that has rendered it obsolete has generated a broad political backlash against new reciprocal market-opening agreements. Part of that backlash has embodied controversial demands, resisted by many 'free-traders' at home and abroad, that future negotiations lead to enforceable labor and environmental obligations. These social issues have undercut the longstanding, pro-liberalization consensus in the US Congress.<sup>2</sup> And division over these issues has been exacerbated by increasing partisan polarization in the Congress generally, and the House of Representatives in particular.<sup>3</sup>

If the domestic politics of trade has therefore become a hard slog, the international side has become forbidding as well. Progress on global trade issues has been painfully slow since completion of the Uruguay Round ten years ago. The breakup of the Doha Round talks at Cancun in September 2003 gave graphic illustration to the difficulty. A herculean effort by developed and developing countries alike succeeded in putting these talks back on track at Geneva in July 2004, but the road to final agreement remained filled with pitfalls. Hence, more than ever, on both the domestic

<sup>1</sup> I present evidence for this in 'The Decline of Traditional Protectionism,' draft Chap. 9 for my *American Trade Politics*, 4<sup>th</sup> edn (Institute for International Economics, forthcoming 2005).

<sup>2</sup> 'New Issues, New Adversaries,' draft Chap. 10 for *American Trade Politics*, 4<sup>th</sup> edn.

<sup>3</sup> 'Partisan Rancor and Trade Politics: The 'Victory' of 2001' draft Chap. 11 for *American Trade Politics*, 4<sup>th</sup> edn.

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and the international front, the lot of the US Trade Representative is not a happy one.

In order to keep the trade bicycle rolling, the present incumbent—Robert Zoellick—has raised the banner of ‘competitive liberalization,’ accelerating the pursuit of bilateral and regional agreements with willing partners. FTAs have been negotiated with Singapore, Chile, Australia, Morocco, and Central America, with the first four approved by Congress in 2003 and 2004. Negotiations with a range of other trading partners are underway: Southern Africa, Thailand, Bahrain, Colombia, etc., etc.

But if the international political process of negotiating FTAs has proved easier than Doha or FTAA, the path domestically has not always been smooth. The majority of agreements have sailed through Congress—those with Israel, Canada, and Jordan as well as the four listed above. But the fight for enactment of the North American Free Trade Agreement (NAFTA) was anything but easy, and resistance to the Central American Free Trade Agreement (CAFTA) (now including the Dominican Republic), completed in early 2004, has led to postponement of a Congressional vote until after the November elections.

How can the USTR line up the necessary business support for such agreements? One important device has been a mechanism that has operated largely below the public radar screen—the negotiation of Rules of Origin (RoOs) that build advantages for influential industries into the text of the agreement.

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### 6.1 Background

‘Rules of Origin’ are regulations, often quite detailed, that determine which products (and hence, which producers) will gain the benefits of discriminatory trade agreements. They 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 (and perhaps the satisfaction of labelling requirements). Those who move it across a national border must pay the same required tariff to the importing country, and once it crosses that border it is treated, in most respects, identically with those produced within that importing country. But though MFN remains the governing rule for most trade, there are important occasions when we want to know the origin of a product. One is to enforce trade remedy laws—think of all the country distinctions (legal and illegal) that the Bush

administration made on its steel safeguards during the limited period (March 2002–December 2003) that they were in effect. Two others have been particularly prominent.

One of these, 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 (sewing on a few buttons) 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 rules. But with the scheduled phase-out of the MFA at the end of 2004, and the broader Uruguay Round prohibition against Voluntary Export Restraint agreements (VERs), the incidence and importance of this source of RoOs is evidently diminishing.

By contrast, free trade agreements (FTAs), the second major source of RoOs, are clearly on the increase. If two or more countries agree to eliminate barriers on products sold 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 RoOs, 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. 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 RoOs that is the focus of this chapter and this volume. And it gains salience from 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 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 as country B, 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

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that would simply join two elsewhere-constructed parts together, or sew a few buttons on a shirt, 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 per cent or more of its value was generated within the two member countries: if not, then it could not. The US-Jordan agreement has a similar general rule: an article is eligible for duty-free entry into the United States, for example, if the value added in Jordan 'is not less than 35 per cent of the [total] appraised value.'<sup>4</sup> This would seem to be a reasonable, even Solomonic, general standard. 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. So when it came time to negotiate the North American Free Trade Agreement (NAFTA), they went for a more demanding percentage. As Frederick W. Mayer describes it,

All three [US] 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 per cent. For reasons that reflected their own patterns of production and competitive position, Ford and Chrysler preferred a higher rule, approximately 70 per cent. Autoparts makers had every incentive to push for as high a percentage as possible, since high percentages protected them from foreign competition.<sup>5</sup>

<sup>4</sup> Section 102(a)(1)(B)(I), Public Law 107-43 (September 28, 2001), the United States-Jordan Free Trade Area Implementation Act.

<sup>5</sup> Frederick W. Mayer, *Interpreting NAFTA: The Science and Art of Political Analysis* (Columbia University Press, 1998), pp. 157-58.

Balancing these preferences, US negotiators sought a 65 per cent RoO. Canada and Mexico preferred a number closer to the 50 per cent of Canada-US, to accommodate Japanese and European transplant producers within their borders.<sup>6</sup> In the end, agreement was reached on 62.5 per cent, 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.'<sup>7</sup>

Why? The answer is not subtle. US negotiators required Congressional support in the forthcoming legislative battle. Without the backing of the most important and powerful US manufacturing industry, they did not believe they could win that battle. And at a time of maximum competitive threat from across the Pacific, automakers were looking for every advantage they could get in buttressing their position in the North American market.

## 6.2 Business and government in a new trade game

Autos was the largest US industry involved in the tailoring of RoOs for NAFTA, but its leaders were anything but alone. 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. Why this wildly complex elaboration of rules in an agreement that was supposed to be for 'free trade?' George Will once noted that a true FTA would not require a text of more than two or three pages. So why did NAFTA need two thousand pages?

The answer lies, of course, at the intersection of business economics and trade politics. Because they affect 'who gets what, when, and how,'<sup>8</sup> RoOs are intrinsically political, and interests try to have them crafted to their advantage. But why do they often do so well in the United States? Here we must explore two converging, if contradictory-seeming trends—the decline of traditional, producer-based protectionism, and the erosion of the US political consensus in support of trade liberalization.

<sup>6</sup> The numbers are not strictly comparable, as NAFTA employed a method of calculation different from that in the bilateral pact.

<sup>7</sup> *Interpreting NAFTA*, p. 162.

<sup>8</sup> This 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).

### 6.3 The globalization of US business

Over recent decades, the international engagement of US producers has multiplied. Goods production has declined as a share of the total economy, from 43 per cent in 1970 to 35 per cent in 2000. But over the same period *trade in goods* has grown—from 4 per cent to 10 per cent of GDP.<sup>9</sup> Thus the ratio of goods production to trade (average of exports and imports) has risen even faster—from 0.09 to 0.29. Producers export a larger share of their output. They also import a larger share of their products' final value. And those who lag in exploiting gains from trade face uphill competition from those who do exploit them.

In this context of a globalizing economy, a pure protectionist position becomes harder and harder to maintain. And so we find fewer US industries seeking new protection. The middle 1980s and late 1990s saw similar surges in the volume of US imports, for example.<sup>10</sup> And during the former period, a parade of industries sought (and usually, received) new protection—autos, steel, machine tools, shoes, semiconductors, and last but not least, textiles. During the latter import surge, however, only steelmakers launched a serious campaign for new import restrictions.

Did the others become free-traders? Not exactly. But they did seek ways to come to terms with the more open US economy. They abandoned a strategy of opposition to all new international trade agreements and instead looked for ways to gain advantage *within* these agreements.

### 6.4 The erosion of bipartisan trade consensus

Over the same period, US government officials continued to pursue market-opening trade agreements. And they continued to need producer support to win Congressional approval of such agreements. Industry interests had shifted, on average, in the pro-trade direction, but this did not mean that business would regularly, on its own, supply the political muscle needed. For most firms, the gains *to them* from foreign-barrier-reduction remained uncertain, conjectural, speculative. And the rise of

<sup>9</sup> Trade here is the average of exports and imports, or  $(X + M) / 2$ . Properly speaking, trade/goods production should be seen as a ratio, not a percentage, since trade statistics represent final value of goods bought and sold and GDP represents just the value added to goods in the United States. All statistics are calculated from *Economic Report of the President*, February 2004, Tables B-1, B-8, and B-103 (all are current dollar statistics).

<sup>10</sup> The quantity of US merchandise imports rose by 65 per cent between 1982 and 1986, an exceptionally sharp rate of increase. The same indicator rose by 63 per cent between 1996 and 2000.

social issues, plus partisan polarization in Congress, weakened the broad bipartisan consensus that had been critical to past legislative successes. The narrow political margin for trade policy in the twenty-first century was illustrated (perhaps exaggerated) by the dearly bought, single-vote House margin by which the House approved Trade Promotion Authority (TPA) in December 2001.<sup>11</sup>

The problem of mobilizing support was particularly acute in regional agreements, where it was plausible for the United States to demand serious labor and environmental provisions. Clinton had needed side agreements on such issues to win his uphill battle for NAFTA approval in 1993; nothing comparable was necessary in the overwhelming vote to approve the Uruguay Round/WTO agreements the following year. When House Democrats drafted their alternative TPA bill in 2001, they included a separate and much more demanding set of labor/environment negotiating objectives for regional and bilateral agreements. And the Bush administration's Central America Free Trade Agreement (CAFTA) faced vociferous opposition in 2004 because supporters of labor–environment linkage for its provisions weak in these spheres.<sup>12</sup>

So trade negotiators look for particularized benefits they can offer important industries in exchange for their support. Industries look for ways to gain advantage within the new economics of globalization. Rules of Origin can meet the needs of both. Because they are often detailed and technical, their politics tends to be asymmetric: those who benefit directly are deeply engaged, while others affected only marginally tend to stay on the sidelines. And while, by their very nature, they tilt the balance of advantage in FTA agreements away from producers in the partner nation, these foreign producers typically find restrictive RoOs a tolerable price to pay for assured, preferential overall access to the US market.

### 6.5 Rules of Origin in practice and theory

In some cases, the impact of a RoO may be less than originally apparent. The 62.5 per cent North-American content rule for autos is, on its face,

<sup>11</sup> For an interpretation of that vote, stressing in particular the deep partisan bitterness in the House in general and the Ways and Means Committee in particular, see my 'Partisan Rancor and Trade Politics: The 'Victory' of 2001–2002,' draft Chapter 11 for *American Trade Politics*, 4<sup>th</sup> edn (Institute for International Economics and The Century Foundation, forthcoming).

<sup>12</sup> For an argument on why bilateral and Regional Trade Agreements are particular susceptible to social issue linkage, see my 'Congress and Foreign Trade,' in Robert A. Pastor and

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exceptionally restrictive. The 'Big Three' executives lobbied hard for it, and gave every appearance of needing and valuing it in 1991–92. Despite major 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 in 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 economic weakness.

As Mayer illustrates in detail, the auto executives deployed that political strength in the NAFTA talks as well. The US government adopted their objective as its own, and once the deal was struck, the auto industry joined the broad coalition of supporters that turned the political tide in the fall of 1993. But their gains were limited because the underlying MFN tariff was very low. This was reflected in US negotiator Jules Katz's reply to the outrage expressed by Ford's CEO at the US agreement to drop the percentage from its original goal of 65 per cent: 'We're talking about a 2.5 percent difference on a 2.5 percent tariff.'<sup>13</sup>

Textiles is an even more interesting, and economically more consequential 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 of the alliance was simple: the US apparel industry was the main market for the mills' cloth. The political logic was simple as well: they threatened to block general trade-expansion legislation if their needs for protection were not met. Working both ends of Pennsylvania Avenue, the textile industry got administration after administration to negotiate a comprehensive regime of quotas, first bilateral restraint agreements under Dwight D. Eisenhower, then a general 'arrangement' on cotton cloth and products under John F. Kennedy, broadened to include synthetics and wool products in the Multi-Fiber Arrangement negotiated under Richard M. Nixon. Between 1985 and 1990, they also succeeded in getting Congress to pass, on three separate occasions, bills that would have

Rafael Fernandez de Castro, *The Controversial Pivot: The United States Congress and North America* (Brookings Institution Press, 1998), pp. 121–46.

<sup>13</sup> Quoted in Mayer, *Interpreting NAFTA*, p. 143.

embedded such quotas in US law, in gross violation of the nation's GATT commitments.<sup>14</sup>

But they couldn't get enough House votes to over-ride any of the anticipated three Presidential vetoes that followed. 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. Assuming such an agreement, fewer and fewer domestic apparel firms were likely to survive to use the mills' fiber and fabric. Indeed, many were already going out of business or shifting production overseas. 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 their fabric.

So they parted company with the remaining domestic apparel producers. 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.<sup>15</sup>

For USTR negotiators knowing that NAFTA was politically controversial and looking to broaden its support, this was an offer they could not refuse. So officials and the industry negotiated a particularly ingenious RoO centered on the so-called 'triple transformation test' (also known as the 'yarn-forward rule'). This 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 significantly 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 NAFTA region.

By liberal-trade criteria, the triple transformation test is an abomination. In their comprehensive rating of RoO provisions for twenty product

<sup>14</sup> For details, see my *American Trade Politics*, 3<sup>rd</sup> edn, esp. pp. 29–30 and 197–98. And those who *really* want detailed history may wish to read I. M. Destler, Haruhiro Fukui and Hideo Sato, *The Textile Wrangle: Conflict in Japanese-American Relations, 1969–1971* (Cornell University Press, 1979).

<sup>15</sup> For a comprehensive analysis of the fundamental shift in textile industry trade strategy, see Craig VanGrasstek, 'U.S. Policy in Textile and Apparel Trade: From Managed Protection to Managed Liberalization,' October 23, 2003, <http://www.asiatradeinitiative.org/docs/2004-Feb/44.%20US%20Policy%20in%20Textile%20and%20Apparel%20Trade.pdf>.

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sectors in five separate FTAs, Antoni Esteveordal and Kati Suominen find the NAFTA textile and apparel rules the most restrictive of all.<sup>16</sup> These rules are literally one in a hundred!

But to win the support of a major, traditionally protectionist industry for a trade-expanding agreement was a major political achievement. And the RoO clearly garnered Carolina votes for NAFTA. In the 1991 vote extending fast-track rules that was a *de facto* authorization for the Bush administration to pursue the NAFTA negotiations, Representatives from North Carolina had voted 9–2 in the negative. But this was before the Rules of Origin were 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 similar rules elsewhere. The African Growth and Opportunity Act was enacted in 2000 to provide broad preferential access to the US market for exports from that generally low-trading continent. But easing its enactment path were similar textile RoOs. For the poorest, they are in fact somewhat less stringent—thirty particularly poor sub-Saharan African countries could sell their apparel in the United States duty-free regardless of where the fabric originated, up to a certain ceiling.<sup>17</sup> On the other hand, a restrictive RoO hurts Africa more than Mexico, since apparel is, for many African nations, the primary growth opportunity in manufactures trade. An IMF Working Paper projecting AGOA's impact estimates that the increase in exports would be 'nearly five times [\$400 million] greater' if the law had included 'a rule of origin that requires only assembly in the beneficiary countries—as under the MFA,' rather than the more restrictive, NAFTA-type rule actually incorporated.<sup>18</sup>

The textile industry has also pressed for tightening of rules within the Western Hemisphere, to incorporate provisions that require 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 TPA bill. A textile

<sup>16</sup> 'Rules of Origin in FTAs: A World Map,' Table 7. <http://www.iadb.org/intal/foros/LAesteveordal.pdf>

<sup>17</sup> For a good discussion of textile-apparel RoOs in AGOA and some proposals for reform, see William R. Cline, *Trade Policy and Global Poverty* (Center for Global Development and Institute for International Economics, 2004), esp. p. 103.

<sup>18</sup> Aaditya Matoo, Devesh Roy, and Arvind Subramanian, 'The Africa Growth and Opportunity Act and Its Rules of Origin: Generosity Undermined?' *IMF Working Paper*, September 2002, p. 2.

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.

Trade economists have properly highlighted the degree to which RoOs reduce the welfare gains from FTAs, particularly those of the less-wealthy nations party to them. Kala Krishna and Anne Krueger were pointing to 'hidden protection' from such rules as early as 1995.<sup>19</sup> In the eyes of scholars like Richard Cooper, a key drawback of free trade agreements is that 'the need for Rules of Origin creates a playground for protectionist interests'—RoOs tend to escape public notice because they are 'arcane and technical.'<sup>20</sup> 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'<sup>21</sup>

Those specializing in trade politics have been slower to focus on the issue. Kenneth A. Oye, however, has addressed the broader phenomenon of how the particularity of FTAs can strengthen their political viability. 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.'<sup>22</sup> More generally, such non-MFN 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. Economists Rupa Duttagupta and Arvind Panagariya have modelled the rules-of-origin issue specifically and found that, under their assumptions, 'an FTA that, , ,was voted down in the absence

<sup>19</sup> 'Implementing Free Trade Areas: Rules of Origin and Hidden Protection,' NVER Working Paper No. 4983, January 1995.

<sup>20</sup> 'Comment,' in Jeffrey J. Schott, (ed.), *Free Trade Agreements: US Strategies and Priorities*, Institute for International Economics, April 2004, p.22.

<sup>21</sup> Robert Z. Lawrence citing Richard H. Snape, 'Regionalism and the WTO: Should the Rules Be Changed?' in Jeffrey J. Schott, (ed.), *The World Trading System: Challenges Ahead* (Institute for International Economics, 1996), p. 51.

<sup>22</sup> Kenneth A. Oye, *Economic Discrimination and Political Exchange: World Political Economy in the 1930s and 1980s* (Princeton University Press, 1992), p. 170.

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of ... Rules of Origin may become feasible in the presence of these rules,' even though they reduce overall welfare.<sup>23</sup>

There is a parallel here in the political role of US trade remedy laws. RoOs helped NAFTA in the same way that incorporating a restrictive interpretation of the Uruguay Round anti-dumping agreement helped smooth the enactment of its implementing legislation. And as in the case of the so-called 'unfair trade' statutes, advocates of RoOs 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,'<sup>24</sup> those who oppose restrictive Rules of Origin can be accused of advocating 'circumvention' of the agreement by producers in non-member states. RoOs surely offer political cover for some outrageous specifics. Yet often their advocates can also claim the high moral ground.

For the most part, however, the RoO debate has been among specialists—it has largely escaped public notice—and WTO scrutiny. As one particularly cogent and informative summary of the relevant issues puts it, 'Because most people had the misconception...that the formulation and application of Rules of Origin result from a technical and objective process, few people paid attention to, much less scrutinized, the process of defining and applying Rules of Origin. The lack of transparency was heightened by the complex, technical nature of Rules of Origin, which would have made it difficult to realize that they were being used for restrictive purposes. Furthermore, while the GATT increasingly restricted the ability of countries to use tariffs or traditional non-tariff barriers to protect domestic industry from foreign competition, it did not regulate Rules of Origin. Therefore... By taking advantage of the fact that formulations of the rules and determinations of origin are not technically objective exercises but rather policy-influenced decisions, governments were able to protect domestic industries in a hidden, effective manner.'<sup>25</sup>

<sup>23</sup> 'Free Trade Areas and Rules of Origin: Economics and Politics,' January 2, 2001. [<http://www.bsos.umd.edu/econ/panagariya/apecon/Technical%20Papers/FTA-RoO-rd-ap-pub13.pdf>]

<sup>24</sup> Research 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.

<sup>25</sup> *Free Trade Agreements and Rules of Origin*, Policy Brief 0012, Middle East and Africa Program, International Center for Economic Growth, no author, no date. [The brief is described as a 'verbatim' synthesis of studies by: Olivier Cadot, Jaime de Melo, and Marcelo Olarreaga (1999); Kala Krishna and Anne Krueger (cited above, 1995); Joseph A. LaNasa III (1996); and Mariana Silveira (n.d.).] The web address is: [http://www.iceg.org/NE/policybriefs/P\\_B%28E%2912.PDF](http://www.iceg.org/NE/policybriefs/P_B%28E%2912.PDF)

## 6.6 Concluding Thoughts

For free-traders, restrictive Rules of Origin—like anti-dumping laws—represent a sort of pact with the devil. The backing of their supporter-beneficiaries is often needed for an FTA to become law. So the Lawrence–Snape remedy—outlawing industry-specific rules—could prove worse than the disease—if one believes that the resulting FTAs still represent a net welfare gain.

But if RoOs seem politically necessary in the short run, they are pernicious in the longer run. So the question for pragmatic trade-expanders is the ancient one: Can one dicker with the devil without joining him in Hell? The long experience with textiles in general suggests that the answer can be yes: quota protection for that industry eased enactment of generations of liberalizing legislation, and in the end it was the quotas that eroded, not market-opening trade policy. Experience with anti-dumping legislation is less encouraging, however—these rules have not, on balance, eroded, and their utilization and impact have not discernably declined.<sup>26</sup>

For free-traders, the need is to yield only what one has to, when 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, or at least limit their impact on trade. There are essentially three approaches: one direct and two indirect.

## 6.7 Seek constraints on RoOs in the WTO

Just as the WTO has extensive, enforceable rules bounding the use of contingent protection, it could establish binding constraints on Rules of Origin in FTAs. The WTO does address Rules of Origin generally, but the general descriptive language from the organization’s website is revealing:

The Rules of Origin Agreement requires WTO members to ensure that their Rules of Origin are transparent; that they do not have restricting, distorting or disruptive effects on international trade; that they are administered in a consistent, uniform,

<sup>26</sup> Research on anti-dumping cases for *American Trade Politics*, 4<sup>th</sup> edn, finds no statistically significant trend in numbers of anti-dumping cases or outcomes, up or down, over the period beginning in 1980. There is also no significant difference before vs. after the Uruguay Round agreements of 1994. See Destler, ‘The Decline of Traditional Protectionism,’ draft chapter 9.

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impartial and reasonable manner; and that they are based on a positive standard (in other words, they should state what does confer origin rather than what does not).

For the longer term, the agreement aims for common ('harmonized') Rules of Origin among all WTO members, *except in some kinds of preferential trade—for example, countries setting up a free trade area are allowed to use different Rules of Origin for products traded under their free trade agreement* [emphasis added].<sup>27</sup>

An effort to fill this loophole might be part of a broader elaboration of the seldom-enforced Article 24 that permits FTAs and provides loose guidelines, including one that an FTA should 'not raise barriers to the trade of other [WTO] members.'<sup>28</sup> Possible new rules range from an outlawing of FTAs that are not customs unions (this would largely eliminate the RoO problem) to limits on the content of RoOs, like allowing just 'one rule for all products,' such as 'a certain percentage of value added.'<sup>29</sup> One might also imagine other devices to modify pernicious rules: like a sunset or review provision for RoOs, requiring their reanalysis and redrafting every 5 to 10 years. At this later point, industry leverage might not be so great, since the agreement itself would not hang in the balance.

Under present political circumstances, however, the United States government would surely oppose such constraints. The USTR *needs* flexibility on RoOs to build support for FTAs. Hence the first *indirect* means of constraining Rules of Origin:

### 6.8 Broaden domestic 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 constrain restrictive Rules of Origin is the same way to avoid a Free Trade Area of the Americas being hostage to the Florida orange growers: by broadening the base of support.<sup>30</sup> This means, among other things, responsiveness to social issues Democrats care about,

<sup>27</sup> See [http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/agrm9\\_e.htm#origin](http://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm9_e.htm#origin).

<sup>28</sup> Lawrence, p. 51.

<sup>29</sup> *Ibid.*, p. 52.

<sup>30</sup> Similarly, the narrowness of the political base was a key reason that the just-negotiated FTA with Australia excludes sugar entirely from its provisions, though Presidential electoral politics seem to have played a role as well. See the front-page story in *Inside U.S. Trade*, February 13, 2004.

effective implementation (and further broadening) 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.

Success in this approach would in turn contribute to the second *indirect* means of addressing RoOs:

### **6.9 Reduce the value of RoOs through overall reduction of MFN tariffs**

The auto RoO in NAFTA was of mainly symbolic value because the tariff relief it granted was so modest. By contrast, textile and apparel tariffs remain high, so RoOs convey substantial rents to US-based producers. So the most effective, long-term way to mute their impact is to reduce these tariffs. Of course, bringing down those tariffs that remain is no easy task politically—the height of these ‘tariff peaks’ is not an accident. But if, to repeat the words of Katz, fights over RoOs could be reduced to ‘a 2.5 percent difference on a 2.5 percent tariff,’ RoOs would go the way of the Smoot–Hawley Act of 1930—still on the books, but lacking serious relevance and impact.

