BRIEFING

European Parliament

Future EU-UK trade relationship: Rules of origin

SUMMARY

The United Kingdom (UK) withdrew from the European Union (EU) on 1 February 2020, and moved into the agreed transition period, running until 31 December 2020. The EU and UK have launched negotiations towards a free trade agreement (FTA) that will shape their future trade relationship. Both parties expressed a preference for reducing 'trade frictions' to the extent possible, and rules of origin will play a role in that regard.

Rules of origin (RoO) are provisions in FTAs that govern the conditions under which an imported good is recognised to 'originate' from the FTA partner country and becomes eligible for preferential trade. These conditions are restrictive – implying trade 'frictions' – to various degrees and designed product-by-product, following operation- and/or value creation-based rules. Importantly, the EU's RoO admit the 'cumulation' of preferential origin across other existing FTAs signed by both parties. As RoO thus create incentives for manufacturers to allocate production and sourcing across countries, they are an important trade instrument.

The European Commission and European Parliament favour RoO provisions in the EU-UK FTA that are consistent with the EU template and protect the EU's interest; the UK government has declared that it is seeking 'appropriate and modern' RoO, providing for cumulation across common FTA partners. The EU and UK positions therefore converge in favour of unrestrictive RoO. Nevertheless, the geographical distance between the EU and UK is short and the resulting shipping costs low. In this context, should the UK unilaterally lower its production costs after the transition period – through, for instance, lower labour and environmental standards, and State aid – less restrictive RoO will provide manufacturers with incentives to increase the UK share in the production chain, penalising the EU. This explains the call in the Political Declaration for frictionless trade 'and' the alignment of standards. Indeed, protecting EU interests implies that RoO are likely to be restrictive, unless the UK commits to aligning standards.

In this Briefing

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Background

The UK withdrew from the EU on 1 February 2020, and entered the 'transition period' – also called the 'implementation period' – which runs until 31 December 2020 (unless extended). During this period, albeit no longer a member of the EU, the UK remains part of the EU single market and customs union. It is thus still applying EU tariffs on third countries, and no customs borders have yet been established between the EU and the UK. The UK has expressed a preference for a complete withdrawal from the EU's *acquis*, Court of Justice jurisdiction and common commercial policy. Both parties have expressed a preference for a trade relationship with as few 'frictions' as possible. Combining these preferences leaves a free trade agreement (FTA) as the unique and most likely option, apart from having no specific trading arrangement at all, known as 'no deal'.

In the context of FTAs, rules of origin (RoO) constitute a potential source of 'friction'. They define the conditions for conferring 'preferential origin', which permits the use of preferential tariffs in an FTA. This measure ensures that products are not merely re-routed or shipped via FTA partners to benefit from lower tariffs.[1] Such RoO constitute a whole part of an FTA, typically in a separate protocol or an annex. Given the variation in RoO and their impact on trade, they are widely admitted to be a trade instrument by all means.

How preferential origin is conferred

The core principle of RoO is that a product has its 'origin' in the last place of production and is conferred as a 'preferential origin' as a whole, so that 'preferential trade tariffs' are applied on the whole – and never on fractions of – a product. RoO provisions in FTAs define the conditions that confer preferential origin for each of the product classification code (at chapter, heading, or sub-heading levels) of the Harmonised System (HS) of nomenclature.[2]

Box 1 – Extract from EU-Canada Comprehensive Economic and Trade Agreement (CETA), Section B, Article 2

'… a product is originating in the Party where the last production took place if, in the territory of a Party …, the product:

- has been wholly obtained …
- has been produced exclusively from originating materials …
- has undergone sufficient production …'

RoO distinguish three types of products. First, the products wholly obtained on the territory of one of the parties. Second, the products produced exclusively on the territory of one of the parties. Third, the products that use materials or processing from third non-partner countries in their production chain.[3] Whenever products are wholly obtained or produced exclusively in one of the two parties, origin is automatically conferred. These conditions are most often applied to primary industries, typically extracted minerals, plants and vegetables (grown or harvested), live or slaughtered animals (born and raised), fish when caught in territorial waters.

Whenever the product is obtained by means of materials and processing in non-partner countries – typically processed food and drink, and industrial goods – the FTA will detail conditions that recognise the product is 'sufficiently' processed in the partner country to confer origin.

Sufficient production

Establishing 'sufficient production' is defined on a product-by-product basis and follows rules classified in three categories.

- Change in classification heading in the Harmonised System (HS). A product is considered to be sufficiently worked or processed when it is classified in an HS

classification (at 2-digit level (chapter), 4-digit (heading), or 6-digit (sub-heading)), which is different from those of the non-originating materials.
- Manufacturing of processing operations. Provisions may include a list of operations and processing that qualify for conferral of origin.
- *Ad valorem* percentage criteria. When the added value acquired equals or exceeds a specified percentage, the goods acquire origin in the country where the manufacturing or processing was carried out. The FTA would specify that the value of all or specific originating country should have contributed to 'at least x% of the value-added'. The percentage is indicated for each product heading.

Table 1 gives three examples extracted from the CETA protocol on rules of origin. Primary resources such as live animals must be wholly obtained (born and raised in one party) to confer origin. Manufactured goods, such as motor cars, instead need 5 % originating materials of the total added value.

Table 1 – Rules to confer origin; extracts from the CETA Protocol on rules of origin.

Product heading in the Harmonised System (HS)	Conditions that confer preferential origin
Chapter 1: Live animals	All animals of Chapter 1 are wholly obtained.
Chapter 17 Sugars and sugar confectionary 17.01 Cane or beet sugar and chemically pure sucrose, in solid form	A change from any other heading.
87.03 Motor cars and other motor vehicles	Production in which the value of all non-originating materials used does not exceed 45 per cent of the transaction value or ex-works price of the product.[4]

Several rules may apply to a single product heading, stemming from one or more classes of rules. Each of the three types of rules have pros and cons. Classification and manufacturing rules permit 'sufficient' production to be defined in a clear and straightforward fashion and confer origin independently of external factors (see Box 2). They are thus easier to prove and more predictable for exporters. Nevertheless, they restrict origin to specific operations and omit other operations. Instead, the *ad valorem* rules better reflect partner countries' processing, but require burdensome accounting calculations and are subject to approval by authorities. Also, *ad valorem* rules expose manufacturers to the risk of losing preferential origin due to adverse fluctuations of input prices (see example in Box 2).

Box 2 – *Ad valorem* criteria, input price fluctuations, and risk of losing preferential origin

A drop in a currency or an increase in raw material prices potentially modifies the share of originating value creation in the final price and may cause the loss of preferential origin. For example, a good that is conferred with preferential origin, where the value of the preferential origin processing amounts to at least 50 % of the final price. A partner country manufacturer uses domestic parts and processing in the production to a value representing 50 % of the final price. The value of non-originating steel used in the production represents 20 % of the final price. Should the price of steel increase by as little as 5 %, the share of the originating value in the total value would fall to less than 50 %, and the good would no longer benefit from preferential origin.

The hazard associated with *ad valorem* preferential origin is often mentioned in business surveys (see, e.g., survey of UK businesses). To address this issue, manufacturers need to find a balance between securing *ad valorem* origin and sourcing production to non-partner countries.

Insufficient production

RoO provisions also set out a list of operations that are 'insufficient' to confer origin and will not be taken into account in the conferring of origin. The example below is an extract from the CETA protocol:

- 'breaking-up or assembly of packages,
- washing, cleaning, or operations to remove dust, oxide, oil, …
- ironing of pressing textiles,
- simple painting or polishing operations ...'

Cumulation of origin

In conferring origin, FTAs may 'cumulate' the production value in both of the FTA parties' territories, but also in third countries that contract FTAs with both parties. There are three categories of 'cumulation' provisions.

- Bilateral cumulation is the most standard provision. It confers origin on the last country if the product has originating material and/or was processed in either party with an FTA. In the EU-UK case, EU products that use materials from the UK will count the latter as originating material.
- Diagonal cumulation partially takes account of materials, parts, or components originating from another preference-receiving country, provided they have FTAs containing identical RoO and provision for cumulation between them. Only originating products or materials can benefit from diagonal cumulation.
- Full cumulation consists of taking account of not only originating materials, but also working and process or value added in more than one preference-receiving country. Unlike other forms of cumulation, full cumulation does not require that the goods are originating before being exported from one party to another for further working or processing. Full cumulation means that all operations carried out in the countries participating in an area are taken into account.

Box 3 – Diagonal versus full cumulation: an example.

Three countries A, B, and C have signed bilateral FTAs. A good needs a 50 % originating production value to benefit from preferential origin. The production chain is as follows: country C produces some parts of the good using €50 of non-originating materials, and adds €40 production value. The parts are priced at €100 and shipped to country B, which adds €30 in value. The final good is priced at €120 and shipped to country A.

Country A must determine whether the good benefits from preferential origin.

Diagonal cumulation:

- Parts are imported into B with a 44 % originating value, thus preferential origin is not conferred.
- The final good is imported into A with B's originating value only, amounting to €30 and representing 25 % of the final price of €120, which is below the 50 % threshold.

Full cumulation:

- A confers origin on the values added by countries B and C (= €30 + €40), so that the share of originating value is 58 % (= €70/€120), above the 50 % threshold.
- The final good benefits from preferential origin.

Generally speaking, cumulation of origin widens the set of goods on which preferential origin is conferred. In particular, full cumulation allows more scattered operations among preference-receiving countries. The list of RoO applicable in EU FTAs is published on the European Commission Directorate-General Taxation and Customs Union (DG TAXUD) website. Nearly all EU FTAs provide

for bilateral cumulation, 25 for diagonal cumulation, and 7 for full cumulation. Diagonal cumulation operates between the Community and the countries of the 'pan-Euro-Mediterranean cumulation zone'. Another example of cumulation is provided by the EU-Singapore Free Trade Agreement (EUSFTA), which acknowledges the integration of Singapore in the value chain of the Association of South-East Nations (ASEAN) regional trade area by incorporating the concept of 'ASEAN cumulation'. Singapore-based manufacturers of products are allowed to incorporate raw materials and parts originating from other ASEAN countries as Singapore-originating content.[5] Full cumulation is in operation between the EU and the European Economic Area (EEA), the Maghreb, and Africa, the Caribbean and the Pacific (ACP) countries.

Rules of origin and global value chains

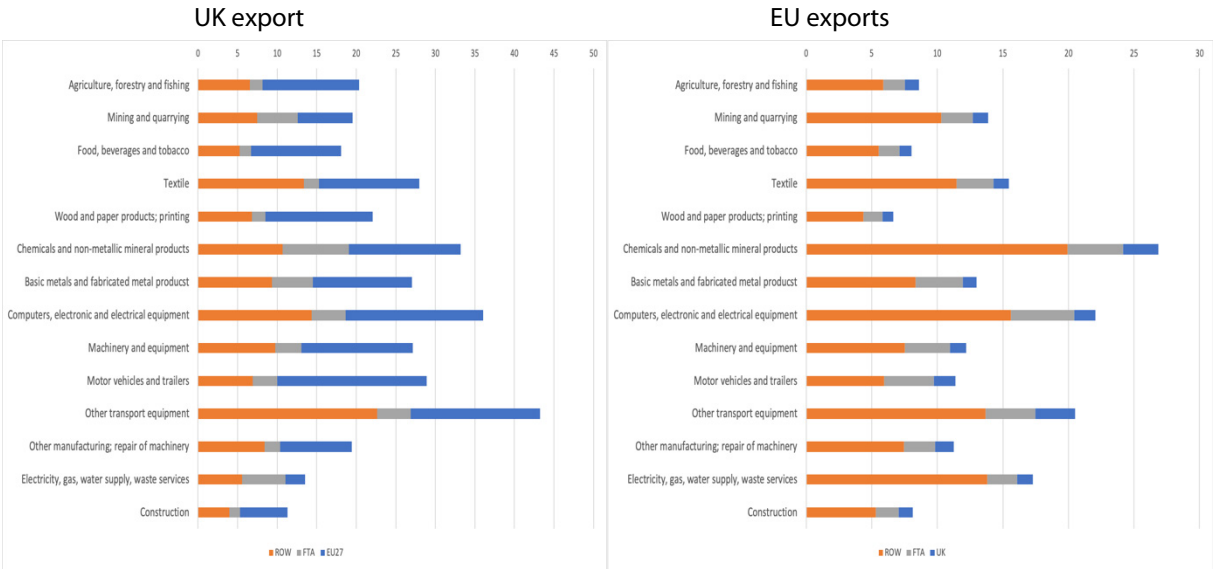
Rules of Origin have an impact on the value chains

Economists and practitioners have proven that RoO have an impact on FTA effectiveness. Two recent surveys of EU exporters and their representatives, conducted by the Commission (2018) on the one hand, and the Committee of the Regions (CoR) and Eurochambres (2019) on the other, show that RoO are the most burdensome requirement for exports and the complexity of RoO was the main deterrent for the utilisation of trade preferences. In addition, RoO criteria and cumulation provisions are empirically proven to shape global value chains (GVC) by creating incentives for firms to switch suppliers in order to meet the RoO. A seminal paper published in Economic Policy estimates that the introduction of diagonal cumulation in EU FTAs in 1997, resulted in significant changes in trade patterns among partners. Similar results are reported in the context of the North-American FTA (NAFTA).

EU-UK value chain interconnectedness

The EU and the UK are major trade partners, which motivates negotiations on an EU-UK FTA. The two countries' production value chains are also substantially integrated. Figure 1 illustrates the foreign input of UK and EU exports in the primary and manufacturing sectors in 2015 (latest available figures). Foreign inputs are split between the UK, the EU, countries with an EU FTA (whenever available in the database), and the rest of the world (RoW). It shows that the EU and UK value chains are highly interconnected, but the UK is far more reliant on EU intermediate goods for its exports in nearly all sectors. Given the high interconnection in EU-UK production, drafting unrestrictive RoO provisions is likely to benefit both the EU and the UK, but probably the UK will benefit more.

Figure 1 – Foreign input share of exports.



Source: OECD Trade in Value-Added (TiVA, 2015), author's calculation.

A further look at UK input in exports is reported in Table 2 (extracted from an OECD study). The figures show that, on average, UK exports receive a relatively large share of domestic value added (85 % average), but in manufacturing UK service inputs actually represent a large share of the added value in the UK's manufactured exports (22.8 %). The integration of services in conferring origin is thus very important for the UK.

Table 2 – Domestic value added in UK exports (2015)

Export Industry	Primary	Manufactures	Services	Total
Total	**3.3**	**20.9**	**60.8**	**85.0**
Primary products	63.3	6.0	18.4	**87.7**
Manufactures	1.4	50.7	22.8	**74.9**
Services	0.3	2.8	88.0	**91.1**

Source: OECD Trade in value-added and global value chains: statistical profiles, OECD TiVA Database.

At the micro-level, practitioners and industry representatives report a strong production inter-connection between the EU and the UK. The car industry is often cited as one example of the challenges that RoO will pose. Some major players in the sector report that the average car made in the UK consists of 44 % of components purchased from UK suppliers, but the proportion of these components actually made in the UK, 'is somewhere between 20 % and 25 %', which is far below the 50 % threshold typically needed to qualify for any FTA. Practitioners express concern that moving to the 50 % threshold would take years, and that the UK does not have the production capability at present. Cumulation is thus essential for UK car manufacturers to access EU markets at zero tariffs. The cost for the UK would be high. The European Automobile Manufacturers Association reports that the UK is home to over 30 production facilities, employing 856 000 people. Some 80 % of UK car components, parts and accessories came from the EU in 2018, representing 16 % of the export value of EU car parts and accessories. Some 60 % of UK-built parts and accessories were exported to the EU, accounting for 18% of EU imports.

In the food industry, similar concerns are voiced by the UK Food and Drink Federation (FDF), which recalls that not only 70 % of food and non-alcoholic drink are exported to the EU, but also that the ingredients in those products are a mix of goods from the UK and non-UK countries. The FDF expresses serious concerns that, due to RoO in the EU-UK FTA, producers find themselves shut out of preferential trade between the EU and the UK, and in effect, would face a 'hidden hard Brexit'.

Why distance matters

Despite the benefits provided by a frictionless FTA, the EU has repeatedly made agreement on the latter conditional on the UK making concrete commitments to the alignment of standards in areas such as social and environmental laws. The levelling of production costs is indeed considered essential to maintaining fair competition between partners (level playing field), whenever trade partners are neighbours and the resulting shipping costs are exceptionally low.

A specific example is that of the defunct North-America Trade Agreement (NAFTA), now replaced by the US-Mexico-Canada Trade Agreement (USMCA). Benefiting from low-paid workers, Mexico's share in the North American production of cars increased over time. In the 2010's, 9 in 11 of the new automotive assembly plants in North America were located in Mexico, and major automotive companies expanded their production capacity in the country. A large share of the cars assembled in Mexico was nevertheless exported to the USA, contributing to a large US trade deficit. The USMCA modified the RoO on cars by requiring an increase in North American material content from 62.5 % to 75 %, as well as steel and aluminium content to 70 %. In addition, under the USMCA, 40-45 % of a car's value should be produced by workers earning at least US$16 per hour. The USMCA also

modified RoO in the textile industry, by requiring sewing thread, narrow elastic fabrics, pocketing, and coated fabrics to be sourced from within North America. All these modifications are aimed at benefiting US producers.

The link between FTA-driven production allocation, RoO and geographic distance has also been scientifically established. A recent empirical study published in the *Journal of International Economics* shows that, in general, transportation costs (due to distance) are larger than tariff gains and, given their complexity, RoO are not justified. However, there are situations where transportation costs are low enough for producers to take advantage of FTAs. In those circumstances, RoO should prevent such opportunistic behaviour and ensure that the production conditions in the partner country are adequate.

Parties' positions

The Commission's proposed mandate for the opening of negotiations with the UK, published on 3 February 2020, states that the envisaged partnership should include appropriate RoO based on standard EU RoO and take account of the EU's interest (COM(2020) 35, clause 20). Generally speaking, the Commission attaches great importance in the FTA negotiations to ensuring RoO convergence, because of the growing number of EU FTAs. Steady RoO across FTAs reduces the cost of complying with different RoO, which would hinder the use of preferences, especially for small and medium-sized firms.

The European Parliament is generally cautious that cumulation may be used by producers as a free-riding tool, while at the same time seeking to simplify RoO to reduce trade frictions. In fact, on the one hand, RoO prevent third country producers from undue access to the EU market through FTA partners, by adding little value. On the other hand, overly restrictive or complex RoO play against frictionless trade. This position is reflected in Parliament's 7 February 2020 resolution on the Commission's proposed mandate for negotiations with the UK. The resolution affirms 'that RoO in the EU-UK FTA should mirror the most recent EU FTAs and be based on the interests of EU producers. The agreement should safeguard the framework of existing commercial relationships between the EU and third countries and avoid any free-riding, by ensuring consistency in keeping a suitable tariff and quota system and RoO for products vis-à-vis third countries'.

In the UK, the government published a document on 27 February 2020, describing its approach to negotiations. According to this document, the RoO provisions in the EU-UK trade agreement should be similar to those in recent EU FTAs, such as the EU-Japan EPA and EU-Canada CETA. These rules should be supported by predictable and low-cost administrative arrangements for proving origin. In line with general practice, these arrangements should reflect the requirements of both UK and EU industry. The agreement should also provide for (bilateral) cumulation between the UK and the EU. It would also be 'appropriate' to include measures that support trade and integrated supply chains with partners with which 'both' the UK and the EU have free trade agreements or other preferential trade arrangements (diagonal cumulation). In its previous written statement to Parliament on the Future Relationship between the UK and the EU published on 3 February 2020, the UK government had already stated that the agreement should set out 'appropriate and modern rules of origin', to facilitate trade between the parties to the greatest extent possible. The statement is consistent with the general concern among business stakeholders in the UK.

The EU and UK positions therefore converge on the use of less restrictive RoO. However, because of the short geographical distance between the two parties and the resulting low transportation costs, the UK may attract a large share of production unless harmonised standards are maintained, thereby ensuring a level playing field. This EU position is consistent with the recent developments in North America and scientific results. Therefore, even though the general objective is to ensure frictionless trade by means of unrestrictive RoO, agreement on the latter is unlikely, as long as the UK downplays the need for harmonisation.

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ENDNOTES

1 In contrast, non-preferential trade is conducted in the absence of any trade agreement on a most-favoured nation (MFN) basis. Under the WTO MFN principle, a country should apply the same conditions on imports for all WTO members.

2 The EU FTAs rely on the Harmonised System (HS) nomenclature, which is the product-classification system developed by the World Customs Organization.

3 For clarity, partner countries are countries which are parties to the FTA; non-partner countries are all other countries.

4 Ex-works price is a widely used international trade term. It is the price paid for the product when it leaves the factory (i.e., ex-works), and thus excludes shipping costs, as well as any internal taxes which are repaid when the product is exported.

5 Many ASEAN countries benefit from the EU General System of Preference (GSP) which offers preferential treatment.

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