

## **UK Trade Policy Observatory (UKTPO) – Written evidence (FFT0025)**

### **UK Trade Policy Observatory**

The UKTPO is a partnership between the University of Sussex and Chatham House that initiates, comments on and analyses trade policy proposals for the UK and trains British policymakers, negotiators and other interested parties through tailored training packages. The UKTPO is committed to engaging with a wide variety of stakeholders to ensure that the UK's international trading environment is reconstructed in a manner that benefits all in Britain and is fair to Britain, the EU and the world.

In this submission we have focussed on question 5 in the terms of reference on the issue of rules of origin, and on the possible arrangements between the UK and the EU. Our submission includes a discussion of precedents in existing agreements, and also of ways of how take up of preferences could be maximised.

#### **A. A primer on rules of origin (ROOs) and why they matter:**

1. Rules of origin determine the country of origin of a traded good. Suppose a UK-EU free trade which allows for tariff-free trade. A good exported from the UK to the EU can only benefit from zero tariffs if it was 'produced' in the UK (and vice versa). This is to prevent the UK from importing a good with zero tariffs from a third country such as China, and then shipping it to the EU duty free (trade deflection); whereas if the good had been shipped directly from China to the EU a tariff would have been paid. Rules of origin are also needed to correctly apply trade remedy measures such as anti-dumping duties or countervailing duties, or to administer tariff-rate quotas.

The origin of a good is therefore not determined by where it was shipped from, but depends on where 'production' occurred. In turn the criteria determining where production occurred need to be established. This is increasingly important in a world of global supply chains where parts and components can be sourced from many countries. Given that different industries have very different production processes, origin rules are often defined at a detailed product level.

2. As an EU member and during the transition period, the UK applies the EU's Common External Tariff and so no rules of origin are needed on UK-EU trade. From January 2021 the UK will have its own tariff schedule. In the proposed UK Global Tariff (UKGT), around 60% of the tariff lines have been reduced compared to their current levels under the EU's CET.<sup>1</sup> Any trade agreement between the UK and the EU will therefore need to include rules of origin.<sup>2</sup>

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<sup>1</sup> For more details on the changes under the UK Global Tariff, see UKTPO blog <https://blogs.sussex.ac.uk/uktpo/2020/05/20/new-tariff-on-the-block-what-is-in-the-uks-global-tariff/>

<sup>2</sup> Rules of origin may also be needed for revenue allocation purposes.

3. Rules of origin are applied to each good that is imported/exported, and not to the firm or the sector. Hence a firm may export two goods to the EU and in order to get tariff free access (in the event of a free trade agreement) the firm will need to prove originating status for each good.
4. The extent to which rules of origin 'matter' depends, in part, on the tariff that would be applied in the event of the firm not being able to prove originating status. For all products where the EU Most Favoured Nation tariffs is zero, then in most cases there would be no need for the firm to prove originating status.
5. Each FTA has its own 'bespoke' rules of origin. One notable exception to this are the EU's Pan Euro-Mediterranean Rules of Origin (PEM).<sup>3</sup> The PEM aims to have common ROOs in the agreements that the EU has with its near neighbours – the EFTA countries, the 10 countries which are part of the Barcelona Process, and the 6 countries of the EU's Stabilisation and Association process in the Balkans.
6. Given that the PEM provides a set of rules of origin that the EU has agreed with a wide range of near neighbours, plausibly the UK could either potentially negotiate to be part of the PEM system, and/or the PEM provides some indication of what the EU may be prepared to negotiate.
7. Rules of origin are complex, and four types of criteria are normally used to determine whether or not a good is deemed as 'originating':
  - a. **Wholly obtained (WO) rule:** Goods that do not use any materials from any other country and are thus entirely produced within the country. This often includes agricultural products or live animals.
  - b. **Value-added (VA) rule:** Specifies the minimum amount of domestic value-added in the value of the product being exported. For example, the rule may specify that there has to be a minimum of 40% domestic value-added embodied in the product.
  - c. **Change in tariff classification (CTC) rule:** this rule considers whether a change of tariff classifications has occurred when looking at what is imported in order to produce the good that is then exported.
  - d. **Specific production process (SP) rule:** Originating status depends on whether a given production process has been used.
8. In practice the rules often contain combinations of the above. This might mean that two requirements both need to be met – for example that the VA rule needs to be satisfied **and** the CTC rule. Or, there may be a choice of meeting either one rule or another – for example you can get originating status either by satisfying the CTC rule, **or** by satisfying the VA rule. The former is typically more constraining, the latter introduces more flexibility into the rules.
  - a. Out of over 5200 HS 6-digit product, in the EU's PEM system the WO rule is applied solely in 11% of cases, the VA rule in 17% of cases, the

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<sup>3</sup> [https://ec.europa.eu/taxation\\_customs/business/calculation-customs-duties/rules-origin/general-aspects-preferential-origin/arrangements-list/paneuromediterranean-cumulation-pem-convention\\_en](https://ec.europa.eu/taxation_customs/business/calculation-customs-duties/rules-origin/general-aspects-preferential-origin/arrangements-list/paneuromediterranean-cumulation-pem-convention_en)

CTC rule in 20% of cases, and the SP rule in 17%. This means that in 35% of the product lines some combination of rules is applied. This varies widely across industries. In Chemicals, for example, this applies in 66% of cases, and in Cars in 20% of cases.

- b. Overall, the CTC rule either on its own or in combination applies for 48% of product lines, and the VA rule either on its own or in combination applies in 49% of tariff lines. In terms of the UK's exports to the EU, a CTC rule applies, either on its own or in combination, to 60% of UK's exports. A VA rule applies to 62% of exports, the SP rule to 23%, and 6% for WO. Hence the CTC and the VA rule are the most prevalent.
9. Both the CTC rule and the VA rules can be determined at different levels of industry or product aggregation, and the level of aggregation impacts on the ease/difficulty of meeting the rule of origin. It is often the case that where a country wishes to protect a particular product it may have a different, more constraining rule, than the rest of the chapter. The broader the level of aggregation at which the CTC rule is defined the more difficult it may be for a firm to meet the rule of origin. Hence, setting the rule at the 2-digit level of the Harmonised System (HS) is more restrictive than setting it at the 4-digit level, and the 4-digit level is more restrictive than the 6-digit level. The PEM typically applies the CTC rule at the 4-digit level.
10. Cumulation of Rule of Origin: This is a term which is used to define the extent to which a country can use intermediate inputs from another country such that those other country's input are also considered as originating. There are several forms of cumulation that could be agreed in a FTA:
- a. **Bilateral cumulation:** This would mean that when exporting to the EU (ie bilaterally) UK producers can count the EU's intermediate inputs as part of the determination of originating status, and vice versa. Bilateral cumulation aims to facilitate bilateral EU-UK trade. Almost all FTAs agree on some form of bilateral cumulation.
  - b. **Diagonal cumulation:** Suppose the UK has an FTA with the EU, and another FTA with Korea. Diagonal cumulation would allow the UK to count inputs which are deemed to be Korean for originating purposes as UK originating when exporting the final good to the EU. The EU's PEM system allows for diagonal cumulation.
  - c. **Full (diagonal) cumulation:** This is a more flexible form of diagonal cumulation. Building on the previous example, even if the intermediate good the UK is importing from Korea is not deemed to be originating in Korea, full cumulation would mean that the UK could still count the amount of Korean VA embodied in that good, and add this (cumulate) Korean VA with the UK VA to determine originating status.

Note: Both diagonal and full cumulation require all parties (in this case the EU, the UK, and Korea) to have bilateral free trade agreements with each other **AND** for all of the agreements to have equivalent (in practice identical) rules of origin. If one bilateral agreement had much laxer rules of origin this could lead to trade deflection in inputs.

- d. **Extended cumulation**<sup>4</sup>: this allows for diagonal cumulation even if all the countries do not have FTAs, and do not have the same rules of origin. Under extended cumulation the UK could use Korean intermediates in exporting a final good to the EU, providing that the definition of what constituted a Korean good is the same as that applied in the agreement between the EU and Korea. Extended cumulation is therefore much more flexible, but is very rarely agreed to in free trade agreements.<sup>5</sup>

11. The OECD's Trade in Value Added dataset can be used to identify the origin of value added embedded in the UK's exports to the EU, and vice versa. This can be seen in Table 1 & 2. In both cases, domestic value added represents the majority of the value added embedded in the bilateral exports. Table 1 shows that, overall across all manufacturing industries, around 11% of the value added in UK's exports is from the EU, whereas the equivalent figure for value added from the UK embedded in EU's exports is around 2% (table 2). This suggests that bilateral cumulation will be more important for the UK than for the EU. In both cases, and for comparative purposes Japan, Canada and Korea make up a relatively small share of total value added in UK's and EU's exports. The non-EU countries which have the highest share of value added in UK exports to the EU are the US, China, Japan, and Canada.

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<sup>4</sup>This is also sometimes referred to as cross-cumulation.

<sup>5</sup> For a fuller discussion see: Jerzewska, A., 2018, Brexit and Origin: A Case for the Wider Use of Cross-Cumulation, The E15 Initiative, available online: <http://e15initiative.org/publications/brexit-and-origin-a-case-for-the-wider-use-of-cross-cumulation/>

12.

**Table 1: Origin of Value Added in UK's exports of manufactures**

UK exports to:	Origin of Value Added in UK's exports (% of total)				
	UK (domestic VA)	EU27	Japan	Canada	Korea
EU27	75.1%	10.9%	0.6%	0.5%	0.3%
South Korea	75.8%	11.1%	0.6%	0.6%	0.3%
Japan	75.6%	10.9%	0.6%	0.5%	0.3%
Canada	73.7%	10.9%	0.7%	0.8%	0.4%

Source: Data based on OECD's TiVA (latest version, for year 2015). Shares calculated using method developed by Belotti et al. (2019)

**Table 2: Origin of Value Added in EU's exports of manufactures**

EU exports to:	Origin of Value Added in EU's exports (% of total)				
	UK	EU27 (domestic VA)	Japan	Canada	Korea
UK	2.3%	82.3%	0.8%	0.2%	0.4%
South Korea	1.7%	83.4%	0.7%	0.3%	0.4%
Japan	2.3%	83.8%	0.6%	0.2%	0.3%
Canada	1.9%	83.6%	0.6%	0.3%	0.4%

Source: Data based on OECD's TiVA (latest version, for year 2015). Shares calculated using method developed by Belotti et al. (2019)

13. The preceding tables are based on the average across all manufacturing industries, and hence the foreign value added shares appear low. This is because they and as such mask both sectoral and firm level variations. Some sectors rely relatively less on domestic value added and more on foreign value added. Table 3 lists the 5 sectors (out of 20 goods sectors) which have the *lowest* share of domestic value added in UK's exports to the EU, and which thus might be more vulnerable to rules of origin, and where cumulation is likely to be more important.

**Table 3: Sectors with lowest share of domestic value added, in UK's exports to EU27**

Sector description	Origin of Value Added in UK's exports to EU27 (% of total)				
	UK (domestic VA)	EU27	Japan	Canada	Korea
Coke and refined petroleum products	57.6%	4.1%	0.3%	0.5%	0.1%
Other transport equipment	67.4%	11.4%	0.9%	0.7%	0.8%
Basic metals	69.6%	10.6%	0.6%	2.3%	0.3%
Motor vehicles, trailers & semi-trailers	70.8%	15.9%	1.0%	0.4%	0.5%
Electrical equipment	72.3%	11.7%	0.8%	0.9%	0.4%

Source: Data based on OECD's TiVA (latest version, for year 2015). Shares calculated using method developed by Belotti et al. (2019)

14. The preceding is based on highly aggregate data, yet rules of origin apply at the detailed firm-product level. ROOs will have different impact on different industries. The most affected industries will be those, for whom imported intermediates are more important (or who supply intermediates, and those where parts and components move several times across many borders (back and forth). For businesses like that it will be more difficult to comply with strict RoOs.
15. Empirical work we have undertaken using ONS and HRMC data show that there is a wide variation across firms and sectors in the extent to which they import intermediates. Sectors where firms have a relatively high share of imported intermediates relative to their exports are Processed foodstuffs, Materials, Textiles, Advanced manufacturing, and Manufacturing and Electronics. Other sectors with slightly lower shares are Chemicals and Automotives. These are therefore sectors which may be more vulnerable to rules of origin either because of the CTC rule or the VA rule.
16. The consequence of not meeting the ROOs is that tariffs would be levied on the product. Products facing higher MFN tariffs are more sensitive to this. Maximum EU MFN tariffs are equal to or above 10% in Processed Foodstuffs, Materials, Chemicals, Textiles, and Automotives, Other transport equipment, and Machinery and Electronics, suggesting these are sectors where the consequences for individual firms (not necessarily for the sector as a whole) of not meeting the ROOs may be more significant.

#### **B. Some precedents:**

17. CETA, EU-Korea and EU-Japan all provide for *full bilateral* cumulation. This means, for example in the case of Japan, that both originating materials from Japan, as well as the production carried out in Japan on materials which did not obtain originating status, is counted towards EU's value added when determining the originating status of a good to be exported from the EU to Japan.
18. The EU's agreement with Canada goes a little further by providing for the possibility of diagonal cumulation with a country with which both parties have a free trade agreement. This is however only possible if the FTAs contain 'equivalent provisions' – which essentially means having the same rules of origin in place. This possibility also exists in the auto sector in the EU-Japan agreement.
19. The UK's existing trade continuity agreements (i.e. the agreements with those countries which the EU has FTAs with) mostly have provisions granting *partial* diagonal cumulation. Hence, in exporting to Chile the UK can count EU inputs as originating, and similarly when Chile exports to the UK. It is partial because it does not allow for diagonal cumulation on exports to the EU, and this is because the EU would need to agree to this.

#### **C. What is the UK proposing in its draft UK-EU FTA text?**

20. The UK's draft text does not contain any detail on the proposed rules of origin, hence it is not possible to comment on the proposed application of the different rules – WO, VA, CTC or SP.

21. The UK's draft text does contain relevant clauses with regard to cumulation:

- a. The UK is proposing to allow for bilateral cumulation with the EU, and also for the cumulation of origin with 'relevant partner countries' (Art.3.3, para 1, and para 2) as well as GSP countries. This appears to be diagonal cumulation though the term is not used, and the UK text is not clear on this, as it does not suggest this applies where identical rules of origin are in place, but where they are 'equivalent'.
- b. In determining origin for purposes of diagonal cumulation the UK appears to be proposing that for the UK's exports to the EU the rules of origin will be those that the UK has agreed with the third (non-EU) country; and for EU's exports to the UK the rules of origin will be those the EU has agreed with the third (non-EU) country. (Art.3.3, para 8). This is a form of extended (diagonal) cumulation but one which the EU is unlikely to agree to (see 22 below).

22. With regard to bilateral cumulation, the UK is proposing full bilateral cumulation i.e. that even if an EU intermediate product is not itself deemed as originating from the EU, UK firms can count the EU value-added in that product when using the input in a final good being exported back to the EU (Art 3.3, para 2). This is quite common in free trade agreements. However, in the EU's draft Treaty text it does not appear to offer full bilateral cumulation.<sup>6</sup> This is an important difference which will need to be negotiated.

23. With regard to diagonal cumulation, on the face of it, the UK's position on which rules of origin should apply (see 21(b) above) opens up the possibility that the UK could have laxer rules of origin than the EU with a given partner, such as Korea, making it easier to use Korean intermediates in the production of exports, and hence making it more competitive in the EU market. This is very unlikely to be acceptable to the EU. However, Art 3.3 para 8, needs to be read in conjunction with para 11, which states that such cumulation can only occur where the UK and the EU apply 'equivalent' rules of origin with the third country. To date, and to our knowledge, while the term equivalent has been used in previous EU agreements, in practice this has meant having identical rules of origin. The UK therefore appears to be requesting diagonal cumulation which depends on equivalent (identical) rules of origin, but there is some ambiguity here.

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<sup>6</sup> The text in CETA states: (1) A product that originates in a Party is considered originating in the other Party when used as a material in the production of a product in that other Party; and (2) An exporter may take into account production carried out on a non-originating material in the other Party for the purposes of determining the originating status of a product. In the text for the proposed agreement with the UK, the EU currently is only offering (1), and not (2).

## **D. Recommendations: How to maximise take-up of trade preferences and what might the UK be able to negotiate?**

24. With its near neighbours the EU has been keen to agree and apply the PEM. Therefore, one possibility is for the UK to seek this option. There are currently 25 non-EU countries signed up to the PEM<sup>7</sup>, these countries account for 9.2% of UK imports in 2019, and 7.2% of UK exports. So this indicates the amount of trade that could have diagonal cumulation if the UK were part of the PEM.
25. An alternative is to obtain a more bespoke deal and get diagonal cumulation with one of the other partners – Japan, Canada, Korea. However, the share of UK exports going to these countries is 1.8%, 1.4% and 1% respectively. So even if this were possible the gains would appear to be small.
- 26.** Outside of the PEM arrangements the EU has rarely agreed to diagonal cumulation. It is therefore unlikely to do so with the UK. Given the partial diagonal cumulation that the UK has agreed in its trade continuity agreements, there is also less incentive for the EU to agree to diagonal cumulation since its exports to the UK already benefit from the cumulation the UK has agreed with its continuity partners. Unless there is an overriding need in particular sectors for the UK to have bespoke rules of origin with the EU (for example because application of the PEM result in tariffs on trade for a given sector with the EU) **we would recommend that the UK aims to be part of the PEM.**
27. It is also possible to introduce and to negotiate sectoral extended cumulation. For example, it could be agreed that in the automobile industry the UK could count Korean inputs for origin purposes in its exports to the EU, where the criterion which determines whether or not the input is Korean is determined by the EU-Korea agreement. However, once again in our view it is very unlikely at this stage that the EU will be willing to negotiate this.
28. If the UK does not wish to or does not manage to agree with the EU to be part of the PEM, it needs to think about how to configure its ROOs to maximise uptake. From the preceding, we infer that the take up of preferences is more likely to be maximized:
- The less complicated are the underlying rules. Hence we would advise minimising the use of 'and' rules, and allowing for flexibility with the use of 'or' rules.
  - If the CTC rule is set at quite an aggregate level then it covers a broader range of products and industries, and so it is less likely that the rule will be met.
  - Where the rule is the VA rule, the lower is the domestic value added content requirement.
  - Product specific rules can be set quite narrowly to protect particular firms / industries and should be treated with caution.
  - The more flexible the cumulation provisions.

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<sup>7</sup> <https://www.consilium.europa.eu/en/documents-publications/treaties-agreements/agreement/?id=2010035>



29. In terms of cumulation there is a clear ranking of what would be desirable from least (bilateral) to most (extended) favourable:

- i. bilateral cumulation
- ii. diagonal cumulation
- iii. full / total cumulation
- iv. extended cumulation

30. There has not been the scope in this submission to discuss areas such as 'de minimis' and 'tolerance clause'. But we note that flexibility can be introduced with regard to each of these elements, and we also note that the more the bureaucracy underpinning ROOs and the more the paper work can be submitted electronically the lower the bureaucratic costs associated with proving originating status.

**13 July 2020**