Comments

Pablo Sanguinetti: This is a very interesting paper that deals with an important and often neglected aspect of preferential trading agreements (PTAs), namely, the determination of rules of origin. Rules of origin are the regulations that determine under what circumstances a good is considered to be produced in the region and thus able to enjoy the preferential tariff treatment. The definition of these regimes, which is mainly the concern of lawyers and policy practitioners, could have important economic impacts on trade and investment flows. Rules of origin have therefore become an alternative trade policy instrument targeted by governments and especially by the private sector in the integrating countries.

The paper does four things. First, it offers a very complete and detailed survey of the various rules-of-origin regimes that have been put in place in the context of the huge increase in PTA initiatives for the world economy and the Americas in particular over the last fifteen years. Second, the paper draws on the political economy literature to examine why the use of rules of origin has become such an important policy for government and private sector lobbies and why the level of restriction implied by rules of origin has increased over time. Third, given what the (positive) theory predicts regarding why rules of origin are established, the paper summarizes the evidence about the effects of these regulations on trade and investment flows. Finally, the paper ends with policy recommendations. I concentrate my comments on the first two of these issues: the features of the various rules-of-origin regimes in the Americas and the political economy aspects of these rules.

On the Extension of the Restrictive NAFTA Model in the Americas

The paper concludes that the NAFTA model of rules of origin, which has been widely applied in the Americas since the second half of the 1990s, is much more restrictive and selective than the rules included in previous

agreements like the old LAIA system and also those applied in Mercosur and in the free trade agreements between Mercosur and Chile and Bolivia. Is this bad news for free trade in the region? To a certain extent, it is not surprising that the NAFTA model has been extended to various free trade agreements in the Americas. Many of these new free trade agreements were signed by NAFTA member countries (including all the bilateral free trade agreement signed by the United States), which presumably would establish similar rules in their new agreements in the interest of internal consistency and for the same political reasons that originated the NAFTA rules-of-origin system. It is also not surprising that the NAFTA-type rules-of-origin regime is more restrictive than those established in previous preferential trade initiatives. As the authors mention, initiatives such as LAIA were much less ambitious than NAFTA, and many sectors and goods were exempted from free trade. Import-competing producers did not have to ask for an alternative mechanism to receive some sort of import relief because they were already excluded from the agreements. The free trade agreements signed since the beginning of the 1990s, however, are more in accordance with Article 24 of GATT in that they cover a significant part of trade and go much deeper in terms of eliminating trade barriers (even compared to unilateral or multilateral liberalization schemes). Governments and import-competing sectors naturally try to target additional measures like rules of origin to ease the cost of adjustment for sensitive sectors. This reasoning implies that this development is not necessarily bad news for free trade in the Americas, since the extension of rules of origin is precisely a reaction to further trade integration. On the other hand, the impact of these added restrictions may partially undo the gains from liberalization resulting from decreasing tariffs.

Mercosur differs from NAFTA in that it is an incomplete customs union, which has certain advantages. Since the main normative argument for adopting rules of origin is to avoid trade deflection (that is, imports entering the member country with the lowest tariff and being reshipped to the other partners with no additional tariffs), rules of origin are not relevant for items that have already converged to the common external tariff of the trade union. One would therefore expect a more lenient regime in Mercosur than in NAFTA. By the same argument, Mercosur rules of origin should also be less restrictive than those included in the free trade agreements signed by Mercosur with other countries, like Chile and Bolivia. Table 3 presents an index that measures the degree of restrictiveness of the Mercosur, Mercosur-Bolivia, and Mercosur-Chile regimes. The index

TABLE 3. Mercosur: Rules-of-Origin Index, by Manufacturing Sector[a]

Sector	*Mercosur*	*Mercosur-Bolivia*	*Mercosur-Chile*
Food, beverages, and tobacco	1.3	1.7	1.4
Textiles, apparel, and leather	1.8	2.9	2.9
Wood products	1.0	1.7	1.4
Paper and printing	1.2	1.4	1.3
Chemicals	2.5	2.7	2.6
Nonmetallic products	1.1	1.2	1.1
Basic metal products	1.7	2.6	2.6
Metal products, machinery, and equipment	1.6	2.0	1.9
Other manufacturing products	1.0	1.3	1.2
Total	1.7	2.3	2.2

Source: Sanguinetti and Bianchi (2005).

a. The index ranges from one to four, with one being the most lenient regime and four the most restrictive.

ranges from one to four, with one being the most lenient regime and four the most restrictive.[1] The overall level of restriction implied by rules-of-origin rules is 1.7 for intra-Mercosur trade, 2.2 for Mercosur-Chile trade, and 2.3 for Mercosur-Bolivia. The table also shows that sectors like textiles, chemicals and basic metal products (steel) are among those most affected by these regulations. Estevadeordal and Suominen find similar results for NAFTA.

Despite the fact that Mercosur is an incomplete customs union (so that rules of origin should only matter for items that are exempted from the common external tariff, as mentioned above), in practice, the rules-of-origin regime is applied to all items independently of whether they are included in the common external tariff. This evidence confirms that these rules are used not only for the normative prescription of avoiding trade deflection, but also as a policy tool that could potentially offer some type of import protection.

On the Political Economy of Rules of Origin

Given that rules of origin can function as a protectionist device within the context of free trade agreements, how does a political economy approach change the normative prescription about the emergence of free trade agreements and the role of these regulations? What are their determinants, and

1. This index is developed in Sanguinetti and Bianchi (2005) and closely follows the methodology presented in Estevadeordal (2000).

how do they relate to other key trade policy variables like tariff preferences? The paper addresses some of these concerns, but I wish to offer some comments to complement the authors' discussion.[2]

Grossman and Helpman provide a political economy model of the emergence of free trade agreements.[3] According to their approach, the decision of whether to form a free trade agreement is subject to political pressures from the potential losers and winners of trade creation and trade diversion. Grossman and Helpman use the term enhanced protection to describe trade diversion and reduced protection for trade creation (relative to the tariff-ridden situation prevalent before the free trade agreement). This approach suggests that exporters that stand to gain the most from trade diversion in the partner country will be most in favor of establishing the trade agreement, while import-competing sectors that will suffer from trade creation originating in imports from the other members will most vividly oppose the free trade agreement. Thus producers will support a free trade agreement when the probability of generating trade diversion is maximized and trade creation is minimized. This is the case when, from a normative point of view, a free trade agreement is not fully justifiable. In practice, the final result will depend on how efficient these different groups are in influencing government policy through lobby activity and how the government objective function weights consumer welfare vis-à-vis that of producer groups.

The original Grossman and Helpman model does not address the issue of intermediate inputs, so it cannot be easily applied to study the endogenous determination of rules of origin. This extension is provided by Cadot, Estevadeordal, and Suwa-Eisenmann, who present a simple partial equilibrium model in which two countries (North and South) engage in a free trade agreement and both tariff preferences and rules of origin are jointly determined.[4] They focus on a case in which intermediate-good interests in the North wish to use the free trade agreement to create a captive market for their product. These interests lobby their government (though political contribution, as in Grossman and Helpman) to establish strong rules of origin to obligate Southern final-good producers to source in the North in order to qualify for preferential access. This clearly reduces the effective protection that the Southern producers receive for entering into the final-good market in the North. The authors assume that the South is always on

2. My comments are based on Sanguinetti and Bianchi (2005).
3. Grossman and Helpman (1995).
4. Cadot, Estevadeordal, and Suwa-Eisenmann (2003).

its participation constraint (that is, effective protection is zero).[5] In this context, deeper tariff preferences for the final goods can sustain stricter rules of origin. This, in turn, favors the Northern producers because it raises both the demand for their product and, more important, the intermediate-good price. The model thus delivers the interesting prediction that this price is not tariff ridden, but depends on demand and supply (as if the market for this product were closed). This is not surprising; rules of origin function as a type of quantitative restriction. This framework leads to the testable implication that the restrictiveness of rules of origin and tariff preferences are positively associated. This positive association is documented in Estevadeordal for NAFTA and in Sanguinetti and Bianchi for Mercosur.[6]

Summary Remarks

As I indicated at the beginning, this paper by Estevadeordal and Suominen is a very interesting piece of work that carefully analyzes the political, economic, and policy implications of rules-of-origin regimes in the Americas. I hope this survey-type of work encourages further research on the topic.

Alberto Trejos: I quite like this paper, which thoroughly addresses the topic of rules of origin in current and future free trade agreements in the Americas. Motivations for this kind of work include concerns that the growing complexity of the administration of rules-of-origin regimes will be compounded as very disparate rules are implemented across different agreements; the problem that many free trade agreements may use stringent rules of origin as an alternative (and less visible) mechanism for maintaining high rates of protection; and the possibility that such disparate rules of origin will turn free trade agreements into a stumbling block, rather than a building block, in the process of world trade liberalization. Understanding this topic is necessary if governments are to design the correct policies, including better free trade agreements, in the future. The

5. In this case, exports of the final good will not increase significantly as a consequence of the free trade agreement initiative. Thus the lobby for stronger tariff preferences by the intermediate-good industry in the North will not face strong opposition from the final-good industry in the same country. There will be very low trade creation in final goods and a strong trade diversion in intermediates.

6. Estevardeordal (2000); Sanguinetti and Bianchi (2005).

majority of world trade (especially within the Americas) happens today in the context of free trade agreements or other preferential arrangements in which rules of origin are applied. Previous work by the same authors illustrates that in the Western Hemisphere the prevalent rules-of-origin regimes are indeed more restrictive and heterogeneous than in the rest of the world.

When rules of origin are binding, they can have some of the same effects as tariffs and other barriers to trade. They discourage trade, require learning, reduce the rate of utilization of free trade agreements, and redirect investment and trade. Furthermore, the costs of compliance can be very high, reaching 2 percent of the total value of trade in some cases. While not as effective as tariffs when used as trade barriers (especially in comprehensive free trade agreements in which tariff phase-out takes place across almost all goods), they provide protectionist measures that the general public does not always see and that policymakers have a hard time quantifying.

The authors measure and assess rules-of-origin regimes according to the stringency of the rules, the cost of implementing them, their nature, and their heterogeneity within and across agreements. They find a very high diversity of rules of origin in the existing free trade agreements and preference regimes in the Americas, both across agreements and across goods within a given agreement. The rules of origin can also be very stringent, especially in older free trade agreements.

At the same time, the authors demonstrate that there are some sources of optimism on this topic. First, newer agreements are less restrictive. Second, as economies become more open and the results of enhancing trade are appreciated, it becomes easier for governments to negotiate agreements that boldly go beyond their predecessors. Third, countries that are now negotiating new free trade agreements show signs of significant learning from a decade or so of implementing their older agreements. Fourth, to remain competitive in an environment where others are doing the same, negotiators of new agreements are producing further liberalization than in previous agreements. Finally, the most recent free trade agreements have been negotiated in the context of an imminent Free Trade Area of the Americas (FTAA), which would much reduce the effectiveness of rules of origin as trade barriers. (This factor will probably be less meaningful in free trade agreements negotiated after the modest results of the Miami ministerial of 2003, which much delayed the expected time of completion of a comprehensive FTAA.)

I would add to these causes for optimism the fact that recent agreements include a variety of new flexibilities to make rules of origin less stringent. De minimis clauses, phase-ins, tariff preference levels, and, most important, accumulation of origin are the most important of such flexibilities. The authors similarly mention the possibility of building on the progress at the WTO on multilateral harmonization of rules of origin in a most-favored-nation basis; I am not optimistic about achieving relevant progress there at this time.

While criticisms of the restrictiveness of rules-of-origin regimes are largely valid, the political economy of trade negotiations is such that restrictive rules of origin are often the only way to maintain a particular product in the tariff phase-out commitments of a free trade agreement. Not only do rules of origin give the local producer of the good more protection (in which case the rules of origin undo some of the progress attained in the phase-out), but restrictive rules of origin create other winners (the regional producers of the key inputs to that good), often tilting the balance. Trade diversion toward the parties involved in a free trade agreement is always politically more feasible than trade diversion away from them, and this is used in negotiations to generate political backup for further liberalization. A flexible rule of origin (which is always preferable, of course) may reduce the feasibility of achieving a quick tariff reduction in the first place by shifting the sourcing of materials to third countries. Under that light, one may see restrictive rules of origin as a necessary, and transitory, evil in some cases.

The authors neglect to look carefully at the growing web of subregional agreements in the hemisphere. Mercosur, the Andean Pact, CARICOM, and the Central American Common Market involve plans of economic integration that go much further than current free trade agreements. These efforts will probably converge to a situation in which nations that belong to the same subregional group, in their efforts to construct customs unions, will homogenize their existing bilateral agreements with third parties, committing to the same rules of origin and allowing for origin accumulation among the subregional partners. This will probably take a long time to come to fruition, but when it does it will significantly simplify the "spaghetti bowl" problem and reduce the distortionary impact of rules of origins.

The authors should also address the question of how rules-of-origin regimes differ across free trade agreements in another way: while rules-of-origin procedures may be very heterogeneous across different goods within a given free trade agreement, specific goods might be treated similarly

across different free trade agreements. My impression is that this is the case for some of the problematic goods, so the effects of current rules-of-origin regimes on FTAA and on future integration are less daunting than a first read of the paper may suggest.

In general, accumulation of origin that is not limited to subregional partners is a significant source of optimism that the hemisphere's rules of origin will become less onerous, both as trade barriers and as administrative costs. For example, four distinct (but quite similar) agreements existing today bind together, in all directions, a group of four nations (namely, Canada, Chile, Mexico, and the United States). Costa Rica will join this group with the enactment of CAFTA, as will the other Central American Common Market partners once their agreement with Canada is in place. It should be feasible and desirable for nations in this list to allow, in their bilateral agreements, origin accumulation with other nations in the list, as the direct market access to those other parties has already been granted. That bottom-up mechanism may result in a better way to construct hemispheric integration and solve the problems of the complexity and stringency of rules of origin.

In conclusion, this is a very good and important paper. It is not easy to figure out how to address this question systematically, and the technical work required for that purpose is certainly daunting. The authors clearly do a good job there. They ask the right questions and raise many key points. Perhaps some topics (origin accumulation, in particular) deserve more attention than was given to them, but the effort clearly achieves progress.

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