

ISSUE BRIEF

No. 4027 | AUGUST 27, 2013

Rules of Origin Can Make or Break the Trans-Pacific Partnership

Derek Scissors, PhD

A trade agreement's rules of origin indicate how to treat goods and services from sources that are not party to the agreement. Modern global commerce is characterized by sophisticated chains of manufacture and assembly across multiple countries. Rules of origin have thus become more important, contentious, and complex. For the Trans-Pacific Partnership (TPP), billed by its supporters as a "21st-century trade agreement" and a template for other major trade talks, rules of origin may be vital.

As with many aspects of the TPP, there is little public information on the negotiated rules of origin.¹ Trade agreements can be undermined by complex rules, which confuse companies and cause them to forgo the new opportunities created by the accord due to fear of penalties. In addition, rules of origin serve as an important signal of the principal goal of the agreement: to liberalize or to exclude. As the global trade leader, the U.S. should strive for simple and open rules of origin in the TPP.

The Basics. Rules of origin can be the most important part of a trade agreement. Without rules of origin, any trade agreement is essentially global—the new opportunities are available to any country,

not just those party to the agreement. At the other end, the complete exclusion from liberalized market access of any goods or services produced by non-signatories completely warps a free trade agreement, turning it into a bloc.

Rules of origin therefore say a great deal about ultimate objectives. In the U.S., the TPP has been promoted as being open to all countries in the Asia-Pacific Economic Community willing to meet its new requirements.² A restrictive set of rules of origin would indicate that the primary method of adding members is coercion: maximizing the difference between being party to the agreement and not being party.

While such an approach may be sensible in some instances, it has a considerable drawback: It punishes member countries that have important partners outside the accord. Essentially, parts of the economies of these countries—the parts integrated with non-member economies—are excluded from the agreement. If the outside parties do not later join, member countries gain from enhanced trade with each other but lose because the supply chains with non-members are broken. On a net basis, the agreement brings less prosperity.

Another important feature is complexity. Beyond the harm to member states from less integration with non-member states is a variant of the "noodle bowl" problem.³ The U.S. and other TPP members have multiple trade agreements with multiple outside parties, often featuring complex rules themselves—"noodles" that are hard to separate. If the TPP's rules of origin are also complex, it will be difficult for firms and individuals to determine how to take advantage of the TPP liberalization without

This paper, in its entirety, can be found at <http://report.heritage.org/ib4027>

Produced by the Asian Studies Center

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

risking penalty. Many economic actors could proceed without regard to the TPP, neutralizing its impact.

It is highly unlikely that the TPP will be rendered meaningless by poorly considered rules of origin, but its value could be considerably reduced. Ideally, rules of origin will be as simple as possible. A key element of this simplicity is having one set of rules that apply to all parties and all relationships, with no haphazard exemptions and departures for certain goods or countries. The TPP parties wisely agreed to this single set of rules in 2011.⁴ The common set of rules itself should also be as simple as possible.

A Specific Example: Textiles. The best-known industry illustration of the importance of rules of origin is consumer electronics. Components of computers, for example, are produced and assembled in multiple countries.⁵ The TPP's rules of origin will exert a powerful influence on this supply chain.

While the U.S. has typically favored liberal rules of origin in electronics, it has done the opposite in textiles. The textile supply chain is extensive, starting with cotton and ending with multi-component pieces of clothing. The standing American position on textile rules of origin is known as “yarn forward,” meaning that all constitutive products in a garment, starting with the yarn and going forward, must be made by a party to the agreement (pre-yarn materials are allowed to come from outside parties).⁶ The TPP remains irritatingly secretive, but there is little sign that a looser rule has been adopted.

Yarn forward is a clear example of a rule of origin intended primarily to exclude rather than liberalize. It is a relic of a time when textile trade was still governed by the quotas agreed to in the 1974–2004

Multi-Fibre Arrangement and protectionism dominated textile trade. To maximize gains from textile trade, TPP members must have the freedom to source materials and component products from the best suppliers—to create the best supply chain. Yarn forward sacrifices this freedom for the sake of maintaining restrictions on outside parties, diverting trade rather than creating it.

Yarn forward puts a spotlight on Vietnam. The principal benefit for Vietnam in joining the TPP is unimpeded textile market access in the U.S. In return, Vietnam will engage in powerful and difficult pro-market reforms across its economy, creating a vibrant economic partner for the U.S. and an ally in promoting open trade. The TPP provides strong incentives and an excellent opportunity for loosening the yarn-forward rule. On the other hand, if the U.S. once again prioritizes its very small textile industry, it sets a terrible precedent for other countries to make analogous demands regarding rules of origin.

Liberalization Should Be the Goal. The World Trade Organization's Doha Round is comatose. Any trans-Atlantic partnership is years away and fraught with difficulty. The TPP is not just an important agreement in itself; it is the launching point for the next generation of global trade deals. Will future agreements liberalize wholeheartedly or half-heartedly or perhaps even close as many doors as they open?

The U.S. wants its partners to push themselves with regard to liberalization, to expand market access in services and investment, not just goods. Restrictive rules of origin will greatly harm that effort directly, and also indirectly, by making it appear that America seeks to open only those sectors

-
1. Ian F. Ferguson et al., “The Trans-Pacific Partnership Negotiations and Issues for Congress,” Congressional Research Service *Report for Congress*, June 17, 2013, <http://www.fas.org/sgp/crs/row/R42694.pdf> (accessed August 20, 2013).
 2. U.S. Senate Committee on Finance, “Hearing on Confirmation of Mr. Michael Froman to Be United States Trade Representative,” June 6, 2013, <http://www.finance.senate.gov/imo/media/doc/Committee%20QFRs%20for%20submission%20-%20final%20060813.pdf> (accessed August 20, 2013).
 3. Daisuke Hiratsuka, “Escaping from FTA Trap and Spaghetti Bowl Problem in East Asia: An Insight from the Enterprise Survey in Japan,” Institute of Developing Economies, Japanese External Trade Organization, March 2008, http://www.ide.go.jp/Japanese/Publish/Download/Report/pdf/Ch9_Hiratsuka.pdf (accessed August 20, 2013).
 4. Office of the U.S. Trade Representative, “Outlines of the Trans-Pacific Partnership Agreement,” November 2011, <http://www.ustr.gov/about-us/press-office/fact-sheets/2011/november/outlines-trans-pacific-partnership-agreement> (accessed August 20, 2013).
 5. National Resources Defense Council, “Your Computer's Lifetime Journey,” November 30, 2011, <http://www.nrdc.org/living/stuff/your-computers-lifetime-journey.asp> (accessed August 20, 2013).
 6. American Chamber of Commerce in Vietnam, “TPP Rules of Origin for Textiles and Apparel—‘Yarn-Forward,’” <http://www.amchamvietnam.com/4591/tpp-rules-of-origin-for-textiles-and-apparel-yarn-forward/> (accessed August 20, 2013).

in which it has a comparative advantage. Therefore, the U.S. Trade Representative should:

- Oppose any and all departures from the previous agreement by TPP countries on a common set of rules of origin so that the noodle bowl phenomenon is limited;
- Make this common set of rules of origin as open as possible to avoid creation of a trade bloc; and
- In particular, make clear that the U.S. is not seeking more restrictive rules as a means of protecting

its own uncompetitive sectors, most prominently by liberalizing the yarn-forward standard in textiles.

Worth the Wait? The TPP has been behind closed doors for a long time. The wait will be more than worth it if a sound agreement is struck, setting the tone for the rest of the decade and beyond. Confusing or protectionist rules of origin should not be allowed to stand in the way.

—*Derek Scissors, PhD, is Senior Research Fellow in Asia Economic Policy in the Asian Studies Center at The Heritage Foundation.*