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To Avoid Trade Diversion, Congress Should Liberalize Rules of Origin

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Regional trade agreements (RTAs) have played an important role in global trade liberalization. However, a major weakness of such liberalization is trade diversion. Trade diversion occurs when regions liberalize at an uneven pace and this liberalization redirects trade flows to trade agreement beneficiaries. For example, when the U.S. signs a trade agreement with one country, some trade is diverted to that country from other countries that do not have U.S. trade agreements.

Recent discussions about large and ongoing RTA negotiations, including the Trans-Pacific Partnership (TPP), have highlighted trade diversion and its potential negative effects on economies that border RTA participants. These effects could be particularly acute in poorer countries that are in close proximity to RTA members and have similar economic structures. In these cases, trade diversion could reduce bilateral trade flows with the U.S. and shift supply chains toward RTA members to the disservice of those outside the agreement.

Ideally, trade liberalization should occur on a universal basis, with all countries benefitting. That universal process has stalled in recent years. Trade diversion is a defect of bilateral and regional agreements. However, since these are the only game in town, the U.S. can still take important steps to limit the negative effects of trade diversion both through current trade programs, such as the African Growth and Opportunity Act (AGOA) and the Generalized System of Preferences (GSP). Loosening these programs' rules of origin could help soften fears of trade diversion in future regional trade negotiations that involve the U.S.

Trade Diversion Can Be Harmful

Recently, there has been much discussion of trade diversion and the effects of RTAs and mega-regional trade agreements. Some fear that RTAs could have negative impacts on economies not included in the preferential zone. In the TPP, for example, some fear that certain countries, such as Bangladesh and Cambodia (with export compositions similar to that of TPP-participant Vietnam), could lose production capacity. More favorable tariff rates and trade rules could cause Bangladesh-based and Cambodia-based companies to shift production to Vietnam to take advantage of these efficiencies.[1] This diversion would not be based on any natural advantage of producing in Vietnam instead of Cambodia, but on preferential tariff rules.

Furthermore, a study by the Peterson Institute for International Economics indicates that even China could experience modest trade diversion if a TPP agreement is concluded. Other big losers from trade diversion in this scenario would be India, the Philippines, and Thailand, all of which would likely see exports decline by at least 1 percent.[2] These concerns are echoed among developed economies as well. In a 2013 report, the European Parliament voiced concern that the TPP could divert trade from

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the EU, and suggested that an EU–Japan free trade agreement (FTA) could avoid detrimental effects.[3]

Kimberly Elliott of the Center for Global Development has also expressed concern that mega-regional deals, particularly the TPP, may result in trade diversion.[4] According to Elliott, "If TPP opens the US market to Vietnamese exports of clothing, footwear, and other labor-intensive products, it could be at the expense of Bangladesh, Cambodia, and other poor countries that do not have preferential access in the US market."[5] These concerns have been echoed in the popular media. Vox's Dylan Matthews has expressed similar reservations about the TPP because of claims by some that it could adversely harm Bangladesh and Cambodia, among other regional countries.[6]

These fears are not exclusive to the TPP. Other research highlights concerns that conclusion of the Transatlantic Trade and Investment Partnership (TTIP), another mega-regional trade deal, could be detrimental to external economies. The United Kingdom's Department for International Development has raised these concerns, but concluded that the TTIP's effects on low-income countries would most likely be small and insignificant. However, trade diversion could occur among countries with higher tariffs or countries that are competitive in products that require sanitary and phyto-sanitary rules.[7]

Reduce Effects of Trade Diversion with Flexible Rules of Origin

Whether justified or not, concerns over trade diversion are real. To address these concerns, the U.S. should consider liberalizing the rules of origin for preferential trade programs as an offsetting option. Preferential trade programs, such as the GSP and AGOA, give developing economies preferential access to the U.S. market for thousands of goods. In total, both programs accounted for over $50 billion in imports in 2013.

Currently, rules of origin for preferential programs are relatively strict due to fears that preferential countries may be used for transshipment of goods produced in other countries.[8] Strict rules of origin mean that more local content is necessary to qualify for the preferential rate, and this discourages the production of more complex, supply-chain-intensive products. AGOA and GSP require that at least 35 percent of the "growth, product, or manufacture" be done locally—a much higher rate than for other U.S. trade agreements.[9] Lowering this threshold could help integrate eligible economies into global supply

1. Kimberly Elliott, "Mega-Regional Trade Agreements: Boon or Bane for Developing Countries?" *Global Development: Views from the Center*, Center for Global Development, July 8, 2014, http://www.cgdev.org/blog/mega-regional-trade-agreements-boon-or-bane-developing-countries (accessed June 3, 2015).
2. Peter A. Petri and Michael G. Plummer, "The Trans-Pacific Partnership and Asia-Pacific Integration: Policy Implications," Peterson Institute for International Economics, *Policy Brief* PB 12-16, June 2012, http://www.iie.com/publications/pb/pb12-16.pdf (accessed June 3, 2015).
3. European Parliament, Directorate-General for External Policies, "The Trans-Pacific Partnership and Its Impact on EU Trade," February 2013, http://www.europarl.europa.eu/RegData/etudes/briefing_note/join/2013/491479/EXPO-INTA_SP%282013%29491479_EN.pdf (accessed June 3, 2015).
4. Kimberly Elliott, "Postcard from London—Transatlantic Trade and Developing Countries," *Global Development: Views from the Center*, Center for Global Development, October 29, 2013, http://www.cgdev.org/blog/postcard-london-%E2%80%94-transatlantic-trade-and-developing-countries (accessed June 3, 2015).
5. Elliott, "Mega-Regional Trade Agreements: Boon or Bane for Developing Countries?"
6. Dylan Matthews, "Bernie Sanders Has Picked a Terrible Argument Against the TPP," Vox, May 14, 2015, http://www.vox.com/2015/5/14/8606351/bernie-sanders-tpp-trade (accessed June 3, 2015).
7. Jim Rollo et al., "Potential Effects of the Proposed Transatlantic Trade and Investment Partnership on Selected Developing Countries," U.K. Department for International Development, 2013, http://r4d.dfid.gov.uk/pdf/outputs/misc_ecodev/61075-EU-US_trade_agreement_and_LICs_final_report_no_annexes_P1.pdf (accessed June 3, 2015).
8. AGOA.info, "AGOA's General Rules of Origin," http://agoa.info/about-agoa/rules-of-origin.html (accessed June 3, 2015). The exception is apparel rules of origin for AGOA. AGOA generally grants duty-free, quota-free access for apparel products to the U.S., and has relatively flexible sourcing rules for least-developed countries.
9. Ryan Olson, "The Generalized System of Preferences: Time to Renew and Reform the U.S. Trade Program," Heritage Foundation *Backgrounder* No. 2942, September 10, 2014, http://www.heritage.org/research/reports/2014/09/the-generalized-system-of-preferences-time-to-renew-and-reform-the-us-trade-program#_ftn13.

chains and shift the import composition of preferential programs away from raw materials.[10] For example, countries that currently participate in AGOA and GSP could use more foreign inputs in the items they assemble, increasing the range of products that are available for potential production and export.

Rules of origin in U.S. preferential programs also could be improved by widening accumulation rules. Current programs vary on how much accumulation takes place in a product. Accumulation is the ability to share production of a product between two or more countries. Currently, GSP only allows accumulation of products with countries that are a part of the same association. In this case, two or more GSP-eligible countries in the Association of Southeast Asian Nations, for example, could contribute value to a product as if they were one country. AGOA, on the other hand, allows accumulation of products across the entire agreement. Furthermore, under the "third-country fabric" rule, AGOA-eligible countries can source yarn and fabric for apparel from any country, not just from U.S. producers.

Widening accumulation could help eligible countries with sourcing, allowing them to move up the value chain. It could also help mitigate trade diversion by increasing trade between eligible countries and third countries, including members of the currently negotiated mega-RTAs, such as TPP and TTIP. This would be of immense value to Cambodia, Bangladesh,[11] Thailand, and the Philippines, all of which qualify for U.S. preferential programs and are projected to experience the most diversion from upcoming mega-RTAs. Allowing eligible countries to accumulate with all U.S. FTA partners would help negate any trade diversion concerns once agreements like the TPP are signed.

Congress Should Liberalize Rules of Origin for AGOA and GSP

Mega-RTAs are an imperfect way to liberalize trade globally. Their existence can cause distortions in the global trading network. Because diversion from newly negotiated deals can hurt developing economies, particularly those in South and East Asia that are eligible for U.S. preferential trade programs, reforming the rules of these programs could be an innovative way of offsetting some of their negative effects. This is particularly pertinent as Congress considers the renewal of some of the largest U.S. preference programs, including AGOA and GSP. As part of the renewal and to head off concerns about global trade diversion, Congress should:

- **Liberalize accumulation rules across U.S. preferential programs.** Accumulation under GSP should be expanded to include accumulation with any eligible beneficiary developing country (BDC) and any U.S. FTA partner. Under AGOA, accumulation should be expanded to include all BDCs, AGOA countries, and U.S. FTA partners.

- **Simplify rules of origin compliance costs.** Current compliance increases the cost of GSP use between 1 percent and 5 percent,[12] thereby undermining the competitiveness of BDCs amid an environment of falling global tariffs. Reducing compliance costs for eligible countries can help make trade flows more efficient and countries more competitive.[13]

Ideally, universal trade liberalization would be the best route to mitigating trade diversion. Liberalizing rules of origin is the second-best, but practical, option to limit the negative effects of the proliferation of mega-RTAs.

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10. Ibid.
11. Bangladesh's GSP eligibility is currently suspended due to worker's rights issues.
12. Kevin C. Kennedy, "The Generalized System of Preferences After Four Decades: Conditionality and the Shrinking Margin of Preference," Michigan State University College of Law *Legal Studies Research Paper* No. 09-21, September 26, 2011, p. 196.
13. Olson, "The Generalized System of Preferences."