Study on the economic impact of extending the pan-European system of cumulation of origin to the Mediterranean partners’ part of the Barcelona process

Executive Summary

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Executive Summary

The development of EU free trade agreements with third countries has meant a parallel expansion of rules of origin, with each agreement containing detailed protocols on the applicable rules. The different timing, content, tariff concessions and trade policy objectives of these agreements have resulted in different systems of rules of origin. Since 1997 the pan-European system has been applied to the EFTA countries, the Baltic States and the countries of Central and Eastern Europe (CEECs). In principle the participation of the EU’s Mediterranean partners in the pan-European system was agreed at the Toledo meeting of the Euro-Mediterranean trade ministers in March 2002. The objective of this study is to analyse the economic impact of that extension of the Pan-European system to the Mediterranean area. The study proceeds in three complementary ways. These are:

1. A detailed conceptual analysis of the possible impact of rules of origin and hence of any changes in their implementation as provided by different forms of cumulation.
2. An evaluation of the application of existing rules of origin, coupled with a qualitative discussion of the possible impact that cumulation might bring about.

Each of these principle sections of the report are summarised below, and the rest of the document provides a more detailed discussion.

Section 1: Conceptual Overview:

This section focuses on the principles underlying rules of origin as well as different forms of cumulation (bilateral, diagonal and full); and on an analysis of the economic effects of rules of origin and their cumulation. A stylised partial equilibrium model is used to derive both analytical and simulated results. The principle conclusions are:

♦ In the context of preferential trade liberalisation rules of origin are designed to prevent trade deflection (imports entering a free trade area via the lowest tariff country).

Note on data and empirical coverage of the report:

Given both the time limitations for this report and the real limitations concerning data availability for certain countries, time periods and sectors the empirical work in this study is based on selected countries and sectors. In so doing the study highlights the key areas, and illustrates the potential economic effects as opposed to providing an exhaustive set of results by country and by industry.
Within this context, the economic impact of rules of origin, and thus of cumulation of those rules, is complex which leads to a set of both welfare enhancing and welfare reducing outcomes:

- Rules of origin may lead to:
  - *trade suppression*: more domestic production at the expense of imports and/or
  - *trade diversion* (switching sources of import supply to less efficient suppliers).

- The cumulation of those rules in turn may lead to:
  - *trade creation* - an increase in imports at the expense of less efficient domestic supply,
  - *trade reorientation* – the switching sources of import supply either to more efficient regional partners, or to more efficient world suppliers,
  - *trade expansion* - an increase in trade arising from the decrease in the costs of imports,
  - *trade diversion* – the switching of sources of import supply either to less efficient regional partners, or less efficient world suppliers.

The first three are welfare increasing, while the last is generally welfare reducing.

While analytically these separate effects can be identified, empirically they may be difficult to identify.

An analysis of changing patterns of trade among the existing Pan-European partner countries shows that there is a prima facie empirical case for suggesting that cumulation introduced in 1997, may have impacted upon patterns of trade and production.

### Section 2: Rules of Origin and the Mediterranean Partner Countries:

This section provides a qualitative discussion of some of the key issues concerning the extension of the pan-European system. This is based on an analysis of the existing rules of origin; on detailed discussions with policy makers, and other interested parties such as trade associations. We provide a preliminary empirical overview of the issues raised in the conceptual analysis. The empirical analysis is then formalised in section 3 of the report. The principal conclusions are:

- Rules of origin are strongly perceived by key stakeholders to impact upon patterns of trade and production; consequently cumulation of those rules is also seen to materially benefit industries within the cumulating area.

- Levels of intra-regional trade within the Mediterranean partner countries are very low, whereas geographical specialisation towards the European Union is very strong, the absence of diagonal cumulation of origin may provide one of the plausible explanatory factors for this.
The adoption of the pan-European system of rules of origin would involve practically no change in the actual rules which are applied for Jordan and Egypt, and minor changes for Morocco and Tunisia, but would add the possibility of diagonal cumulation.

Section 3: Empirical Analysis:

Here we provide a preliminary quantification of the possible long run impact on aggregate and sectoral trade and production on the Mediterranean economies, countries of Central and Eastern Europe, EFTA and the EU of the extension of the pan-European system. There are two main sections in this part of the report.

First, supporting empirical evidence on cumulation comes from an econometric analysis using a ‘gravity model’. This evaluates the impact of preferential trading agreements, and the absence of cumulation in the historical trading relationships between the Euro-Mediterranean trading partners. The results suggest that the trade actually taking place between partners that are not part of a system allowing diagonal cumulation of origin with the European Economic Space (EU + EFTA) is lower by up to 40-45% compared to trade flows between countries which do allow for diagonal cumulation.

The second section provides a detailed empirical evaluation of the impact of changes in the rules of origin based on a computable general equilibrium (CGE) trade model. The results suggest:

- strong incentives for trade deflection in the presence of preferential trading arrangements and thus the need for rules of origin to prevent it.

- that cumulation of rules of origin could significantly increase welfare, and manufacturing production in the Mediterranean partners. These gains arise principally from trade creation and trade reorientation.

Overall the empirical studies of cumulation confirm the message derived from the conceptual discussion and from the discussions with key stakeholders that extending the possibilities of cumulation of origin is likely to be beneficial. We expect therefore that the extension of the pan-European system to the Mediterranean partner countries will provide overall welfare gains for these countries.