

COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

**CONCERNING THE UNIFICATION OF RULES OF ORIGIN IN PREFERENTIAL
TRADE BETWEEN THE COMMUNITY, THE CENTRAL AND
EAST EUROPEAN COUNTRIES AND THE EFTA COUNTRIES.**

EXPLANATORY MEMORANDUM

The European Council in Copenhagen on 21-22 June 1993, invited the Commission to study the impact of changes in rules of origin on trade between the Community, the Central and East European Countries (CEEC) and the EFTA countries. The importance of rules of origin in trade development and integration was further underlined by a Commission Communication¹ following the European Council in Corfu on 23-24 June 1994 on further implementation of the Europe Agreements and adopted by the Council on 4 October.

In order to examine the impact of rules of origin and cumulation on industry in Europe, three sensitive sectors, consumer electronics, textiles and automobiles were studied.

This Communication sets out the present situation with regard to rules of origin in preferential trade between the Community, the CEEC and the EFTA countries. An explanation of the main features of rules of origin and the different types of cumulation is included. The benefits of unified rules of origin and extending cumulation possibilities in preferential trade between the EC/CEEC/EFTA countries are examined and political and economic advantages are identified. A progressive strategy is therefore proposed to unify rules of origin and extend cumulation possibilities in several stages.

Essentially, the strategy comprises of three stages; the extension of diagonal cumulation between the Community and all CEEC; the integration of EFTA countries into EC/CEEC cumulation; and thirdly, the introduction of full cumulation into all agreements. It is recognised that in addition to the gradual extension of cumulation, harmonisation of rules of origin throughout the EC/CEEC/EFTA Zone is essential.

The Council is invited to approve the strategy outlined in this Communication, with a view to its endorsement by the European Council in Essen in December 1994.

¹ COM(94)320 Final, COM (94)361/3

INTRODUCTION

The European Council in Copenhagen on 21-22 June 1993 invited the Commission to study the impact of changes in rules of origin on trade between the Community, the CEEC and the EFTA countries. Progressive economic integration before their future accession could help associated countries to assume the economic obligations of membership. It is recognized that the legal provisions in the customs field known as preferential rules of origin are fundamental to trade agreements and help determine the extent of the commercial and industrial links between partners. The importance of rules of origin in trade development and integration was further underlined by a Commission Communication¹ following the European Council in Corfu on 23-24 June 1994 on further implementation of the Europe Agreements and adopted by the Council on 4 October 1994.

In addition to the Europe Agreements, there are several other sets of agreements² governing the commercial relations between the countries of the EC/EFTA/CEEC zone.

In order to exploit the full potential of the Europe Agreements and realise the stated aim of integration and to ensure that economic operators throughout Europe gain maximum benefit from free trade arrangements, a strategy towards unifying preferential rules of origin in Europe is required.

2. EXISTING RULES OF ORIGIN IN EUROPE (EC/CEEC/EFTA COUNTRIES)

Free trade agreements allow access to partner countries' markets at preferential duty rates for goods "originating" in the country of despatch. Origin is determined by the rules negotiated in the context of the trade agreement in question, and may vary from one agreement to another. Goods that qualify as originating products under one agreement may not do so under another if the rules, as negotiated, differ. The existence of a number of agreements, each with their own origin rules, therefore divides Europe into compartments, and impedes both the free flow of trade between different origin "blocs" and the economic development that such a flow can stimulate.

The automobile sector illustrates the present difficulties in taking advantage of the existing preferential agreements in Europe. The automobile sector relies heavily on local distributors for components at the time of manufacture and for replacement parts due to the semi-perishable nature of automobiles. Distributors cannot treat the EC/CEEC/EFTA zone as one preferential market as goods originating within the meaning of one agreement are considered to

¹ The Europe Agreements and beyond: A strategy to prepare the countries of Central and Eastern Europe for accession" - COM(94)320 final 13.07.1994, "Follow-up to the Commission Communication on the Europe Agreements and beyond: ..." (COM(94)361/3. 26.07.94.

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- the EEA Agreement between the Community and most of the EFTA countries (and the bilateral agreements between the Community and the EFTA countries);
- the Stockholm Convention establishing the European Free Trade Area between Austria, Finland, Iceland, Liechtenstein, Norway, Sweden and Switzerland;
- the Europe Agreements between the Community on the one hand and each of the Central and East European countries (Poland, Hungary, the Czech Republic, Slovakia, Bulgaria and Romania) on the other hand;
- the agreements between each of the EFTA countries, on the one hand, and each of the CEEC, on the other hand;
- the Central European Free Trade Agreement (CEFTA) between Poland, Hungary and the Czech Republic and Slovakia.
- In addition, the Community has recently concluded Free Trade Agreements with the Baltic States and is preparing negotiations with Slovenia for a Europe Agreement.

be non-originating within the meaning of other agreements.¹ Therefore, establishing one origin for products within the context of all preferential agreements in Europe would be an enormous gain to economic operators by increasing sourcing possibilities and free trade.

3. HARMONIZATION AND SIMPLIFICATION OF RULES OF ORIGIN

Goods originate in a certain country or area when they are wholly obtained in that country. Examples of "wholly obtained" goods are mineral products extracted within the territory of the country concerned, vegetable products harvested there, live animals born and raised there and fish caught by vessels registered in that country.

Non-originating materials can also obtain origin by undergoing a sufficient degree of transformation or processing within the country or area concerned. The degree of transformation or processing considered sufficient is never easy to define and tends to refer to a processing operation that brings about a significant qualitative change. In practice, protocols on rules of origin usually contain an annex which lists on a product-by-product basis, the required transformation or processing considered sufficient. For example, the EEA rule for consumer electronic products of Heading 84.70 is manufacture in which the value of all non-originating materials used does not exceed 40% of the ex-factory price of the product. This means that an added value of 60% would be required within the EEA before the resulting product obtains EEA origin.

Despite many similarities in the various protocols on rules of origin, there are differences in the degree of liberalization². For example, the Europe agreements contain simplified procedures for the provision of evidence of origin but do not allow for the use of simple invoice declarations; the EEA Agreement does provide for invoice declarations; and the EFTA Agreements with the CEEC allow some limited use of invoice declarations.

Harmonizing the requirements that need to be met for products to obtain origin under the different agreements would cut firms' compliance costs substantially and make the preferential agreements simpler and more attractive to use. Administrative burdens could also be reduced

¹ e.g. A Hungarian factory would have no incentive to use products from a distributor in Switzerland if those products originated in the Community within the meaning of the EC-Switzerland FTA. Likewise, a German distributor would not be able to claim any preferential treatment when exporting Czech products to Romania.

² The main features which are contained in some agreements but not all, are as follows:

- Alternative percentage rules. In the lists of working or processing required to be carried out on non-originating materials in order that the product manufactured can obtain originating status, usually annexed to the protocols on rules of origin, some agreements contain alternative percentage rules (APRs). These APRs, based upon rules which simply specify that the total value of non-originating materials used should not exceed a certain percentage of the ex-works price of the product, apply to certain products in the EC-EFTA/EEA agreements and in the EFTA-CEEC agreements.
- a general tolerance. In order to facilitate trade, a derogation from the working or processing requirements of up to 10% was introduced for certain materials in the EEA Agreement and the EC-EFTA agreements. This provision entered into force for the first time on 1.1.1994.
- Relaxation of the principle of territoriality. Rules of origin are based upon a principle of territoriality which requires that the conditions for the acquisition of originating status must be fulfilled without interruption in one or more of the territories of the contracting parties. As with the introduction of a general tolerance, a limited derogation from the territorial principle of up to 10% was introduced on 1.1.1994 in the EC-EFTA/EEA agreements in order to facilitate trade.
- Administrative cooperation. Differences between the agreements with regard to the procedures concerning administrative cooperation reflect the extent of the commercial evolution between partners and can be seen in the different types of proofs of origin required. For example, EUR.1 movement certificates and in certain cases invoice declarations are acceptable evidences of origin in the context of the EEA Agreement, whereas in the context of the EC-CEEC agreements EUR.1 movement certificates or EUR.2 forms are required.

by further harmonization of the documentary requirements attached to the preferential arrangements.

Preferential rules of origin often contain provisions to ensure that materials imported from third countries have been charged with the appropriate customs duties before they can, after sufficient processing, enjoy the tariff preferences provided for in the agreements. This obligation and the prohibition of the reimbursement of customs duties levied on these materials when they are exported under the terms of a preferential agreement to another country party to the agreement is commonly called "no-drawback".

The EEA agreement, the bilateral EC-EFTA Free Trade Agreements and the Stockholm Convention contain no-drawback provisions. However, this is not the case in the Europe Agreements between the Community and the CEEC¹. In general terms, the absence of no-drawback provisions or their non-application puts third country materials in a better competitive situation than materials originating in the processing country itself.

In cases where all partners to an agreement have similar tariff systems, the no-drawback rule restricts trade circumvention in order to avoid customs duties as well as ensuring that economic operators are not unfairly disadvantaged. However, this does not mean that distortions are completely excluded when no-drawback provisions are applied. Free trade agreements do not oblige members to harmonize customs tariffs, and products charged with a high rate of duty in one country may be charged with a much lower rate in another partner country to the free-trade agreement. Such situations could encourage production to move to countries with lower duty rates in order to gain a competitive advantage.

In order for there to be a uniform, equitable application of the Europe Agreements, the inclusion of a no-drawback rule would appear to be necessary.

4. PROMOTING INTEGRATION BY EXTENDING CUMULATION POSSIBILITIES

In most cases, the rules of origin contained in a Free Trade Agreement specifically provide for a system of "cumulation" of origin so that products originating in one or more partner countries can be used in another partner country to yield a finished product originating in that country. Cumulation promotes cooperation between companies in the countries that are parties to the agreements, favours an optimum use of resources, and as a consequence contributes to improved economic relations.

There are basically three different types of cumulation: "bilateral", "diagonal" and "full". The choice of system depends on a number of considerations, such as the political relations, the geographical situation, the development objectives, the regional cooperation possibilities and the economic interests of the countries concerned.

¹ e.g. Situation in the European Agreements where there are no provisions concerning the no-drawback rule. Alternators destined for the EC market are manufactured in Poland from components originating in Taiwan. Without a no-drawback rule, no customs duty is paid on the components in Poland. Neither is any customs duty paid in the EC, for the alternators are considered to originate in Poland within the meaning of the Europe Agreement. If the alternators had been manufactured in the EC and put onto the EC market, the Taiwanese components would have been subject to 5.6% customs duty. Similarly, Polish manufacturers would have to pay customs duties on components imported from Asia and used in the manufacture of a product destined for the Polish market, whereas an EC manufacturer would avoid paying duties for the same components when the manufactured product was exported to Poland.

- "Bilateral" cumulation¹, the least developed system, operates between two "partners" (e.g., EC/Bulgaria Interim Agreement) and applies only to materials which originate in either of the two partner countries.
- "Diagonal" cumulation² refers to the cumulation possibilities when several countries are party to an agreement or linked by several similar agreements and where the use of materials originating in any of the countries concerned is permitted (e.g., the EC/Visegrad Europe/Interim Agreements).
- "Full cumulation"³ is the system which represents a more advanced form of economic integration between the partner countries. Full cumulation provides for the cumulation of processing between two or more countries. Account is therefore taken of all processing or transformation of a product within the trade zone without the products being used necessarily having to originate in one of the partner countries. One of the results of "full" cumulation might lead to an origin common to all partners (i.e. the EEA Agreement).

A strategy for the progressive unification of preferential origin rules in Europe would rely heavily on an extension of cumulation in the operation of the different free trade agreements. This would help promote greater integration across the borders between partners and would encourage more rational use of resources. However, the choice of the type of cumulation is crucial, since the effects of the different systems can vary substantially.

In the CEEC, the type of cumulation, full or diagonal, would have an influence on the production structure. In a diagonal cumulation system the cumulation of origin would only be possible with products which have already obtained preferential origin status. Generally, the origin rules are such that an added value of 60% would be required; if this threshold was not met the products would not obtain preferential origin and could not be considered for cumulation purposes. Thus, diagonal cumulation requires a significant input in each country that participates, which could not be achieved by simple assembly operations. On the other hand, under a system of full cumulation no such restriction exists and any amount of value added, even when inferior to 60%; would be taken into account and carried forward to the next production step. Full cumulation would therefore maximise the use of available resources but would reduce the substance of each of the consecutive processing operations. Consequently,

¹ e.g. Integrated circuits (HS heading 85.42) assembled in Bulgaria from EC originating microchips of the same heading and other Bulgaria originating materials. The integrated circuits would be considered as originating in Bulgaria and entitled to preferential tariff treatment on importation to the EC, even though the assembly operation in Bulgaria would not be considered as a sufficient process according to the basic processing criteria.

² e.g. Television receivers (HS heading 85.28) assembled in Hungary from components originating in Hungary, the EC and Poland. The television receivers would be considered as originating in Hungary (or Poland, if the Polish content was greater than the Hungarian input.) and would be entitled to preferential tariff treatment on importation into the EC. In both bilateral and diagonal cumulation, the cumulation provisions apply only to 'originating materials'.

³ e.g. US Cotton fibre (HS heading 52.01) is spun into yarn (HS heading 52.04) in the EC, exported to Austria and woven into cotton fabric (HS heading 52.10). Within the context of the EEA rules of origin for textiles, a double transformation is required on non-originating materials for products to be considered as originating. Full cumulation allows the processing in Austria and the EC to be counted together, the cotton fabric is considered to originate in the EEA and can benefit from preferential tariff treatment on importation into any EEA partner country. The Austrian manufacturer, although processing a non-originating yarn can include the earlier process in calculating the origin of the cotton fabric. Therefore, difference between diagonal cumulation and full cumulation is that in the latter system, all processing operations count towards obtaining origin. The yarn would not have obtained origin under diagonal cumulation provisions.

full cumulation tends to favour the use of third country materials whereas diagonal cumulation is less liberal and encourages the use of materials originating within the free trade zone.

The systems of cumulation provided for by the agreements which make up the Community/EFTA/CEEC zone generally all fall under the systems outlined above. However, all agreements only provide for cumulation to take place between partners of the same agreement (or set of agreements) and there is no link at present between the different sets of agreements. For example,

- the agreements between the Community and the CEEC do not provide for any cumulation with the EFTA countries,
- the Central European Free Trade Agreement does not provide for cumulation between the Visegrad countries and Bulgaria or Romania,
- the Free Trade Agreements between the Community and the EFTA countries and the EEA Agreement do not provide for cumulation with the CEEC.

The more liberal a cumulation system is the more it will be used by operators and the more difficult it will become to decide the origin of a product in which a number of preferential countries may have participated in its manufacture. Such an allocation might be based on the country where the last operation took place, or that which has contributed the highest value, or that where the product has been assembled. It is important that a predictable and precise origin allocation is included in any proposal to extend cumulation possibilities. Although the tariff treatment in the Community might be identical for all the CEEC, this will not necessarily be the case among the CEEC themselves. Other instruments of commercial policy might also be affected such as provisions on infant industries, or the application of commercial defense mechanisms.

In order to examine the impact of rules of origin and cumulation on industry in Europe, three sensitive sectors, consumer electronics, textiles and automobiles were studied. The findings of the three sectorial studies are annexed to this paper. The economic advantages of extending cumulation can be summarized as follows:

- improved Community and EFTA market access for products from the CEEC as well as an increased incentive for intra-CEEC trade;
- increased economic cooperation between the Community, the CEEC and the EFTA countries;
- enlarged sourcing possibilities for materials and products;
- improved possibilities for producers to realize economies of scale by organizing their activities on a Europe-wide scale.

However, the examination of the different types of cumulation identified disadvantages towards certain sectors if full cumulation was introduced straight away into all agreements.

These disadvantages can be summarised as follows:

- Negative impact on employment in the Community;
- Increased possibilities for third country materials to obtain preferential origin status and penetrate the Community market;
- Less incentive to create vertically integrated industries in the CEEC;
- Circumvention of the Community's customs tariff.

5. A PROGRESSIVE STRATEGY TOWARDS UNIFIED RULES OF ORIGIN IN EUROPE

The strategy proposed includes the following stages and steps:

first stage

- streamline and simplify the origin aspects of the Europe Agreements with the four Visegrad countries
- incorporate Bulgaria and Romania
- in parallel, consider extending full cumulation to Switzerland

second stage

- diagonal cumulation between the EC/EFTA group and the CEEC
- possible generalisation of the non-drawback rule

third stage

- full cumulation.

Economic cooperation and trade development between all partners would be monitored closely. A thorough evaluation of each stage would be carried out before the Commission considered moving to the next stage.

In more detail, the core of the strategy is based on strengthening the effectiveness of the Europe Agreements. Further work is required to simplify the administrative procedures as well as ensuring that existing cumulation provisions can be exploited fully by economic operators. The structure of the agreements between the European Union and Poland, Hungary and the Czech and Slovak Republics as well as the agreement between these four countries should be modified to incorporate Bulgaria and Romania. It should be recognized that the structure should be flexible and allow the future addition of further CEEC who become associated countries, such as the Baltic States and Slovenia.

Extending diagonal cumulation between the Community and all CEEC would be a first stage towards an integrated system of European cumulation. That extension would be relatively simple once all the CEEC concerned concluded an agreement containing rules of origin that were identical to those contained in the Europe Agreements. The advantages of such a

proposal would be to increase the cumulation possibilities quite extensively between the Community and the CEEC, without there being a pre-condition to change much in the way of the origin rules themselves. The successful implementation of such a system would be dependant on the CEEC all agreeing on one system and on concluding an agreement between themselves. The Community should actively encourage this process.

In parallel, the EEA partners could extend full cumulation to Switzerland. However, it should be noted that any modifications to the EC-Switzerland FTA would need to be considered within the overall framework of the Community's relations with Switzerland. It should also be stressed that progress on EC-CEEC and EC-EFTA negotiations would not be linked.

As a second stage towards an integrated system of European cumulation, diagonal cumulation could be introduced between the EC/EFTA countries, treated as one territory for the purposes of rules of origin and the CEEC. All EC/CEEC/EFTA countries would then be involved in what could be called European cumulation. The main difficulty with this proposal would be that no-drawback provisions are contained in some agreements. Consideration would have to be given to the introduction of no-drawback provisions to all agreements, in order to avoid circumvention.

After evaluation, the third stage would be to introduce full cumulation into all agreements. The whole of Europe would be treated as one territory for the purposes of rules of origin. This would result in a truly free trade area without artificial origin barriers. Examining the impact of full cumulation has shown that although its introduction into all agreements would certainly offer considerable economic advantages in many industrial sectors, there might be negative effects with regard to employment in other sectors, notably the textiles sector. Before moving to the third stage, a thorough evaluation of the sectoral and regional consequences on the European industry of introducing full cumulation would be carried out, taking into account the effects of the first two stages. This evaluation would cover a representative cross-section of European trade and industry and might lead to limited sectoral exceptions. Furthermore, there are major practical difficulties with introducing full cumulation at this stage, and it must remain a longer term option.

6. CONCLUSION

Trade liberalisation has a fundamental economic and political role to play in the creation of market-based democracies. The Commission recalls that in its communication on the reinforcement of the mediterranean policy of the EU, it stressed the importance and interest of including in the long run the mediterranean third countries, which would commit themselves towards a broad free trade area with the EU where the harmonisation of rules of origin and their cumulation should play a major role. Further integration of trade areas through the harmonisation of rules of origin and improved cumulation possibilities has a key role in the reform process, which is vital for Europe. Following the study of the feasibility and impact of rules of origin and cumulation between the Community, the CEEC and the EFTA countries, the Commission is of the opinion that without prejudice to the Community's other commercial policy instruments a clear strategy towards the unification of preferential rules of origin in Europe is required.

Implementation of the strategy, focussing on harmonisation of rules of origin and the

extension of cumulation possibilities in progressive stages would strengthen the effectiveness of the Europe Agreements, improve market access for originating products and stimulate economic cooperation throughout Europe.

The Commission invites the Council to approve the strategy outlined in this communication, with a view to its endorsement by the European Council in Essen in December 1994.

ANNEX I

CONSUMER ELECTRONICS

Consumption in the EC's consumer electronics industry in 1991 amounted to 193,506 million ECU, whereas production in the EC was 166,965 million ECU. Approximately 1,5 million people are employed in the consumer electronics sector. In the period 1982 to 1991 consumption, production and employment have more than doubled.¹

In the period 1982-1991, imports into the EC of consumer electronic products has grown more than EC exports. The compound annual growth of EC imports over that period was 12.5% while the compound annual growth of EC exports was 9%.

For the total consumer electronics industry and for the years 1982-1991 an increase of production and consumption has led to an almost identical growth in employment figures. Assuming that this ratio remains applicable and based on a foreseen annual growth of 3.9% for EC production for the years 1992-1996 (anticipated growth of consumption for the same years, 4.7%) employment would also increase by approximately 4% or 60,000 persons.

EC manufacturers in the consumer electronics industry mostly source components in the Far East. Companies forecast that the future of this sector depends on the development of new and advanced technologies. These new developments will require substantial investments. Expansion of the market share is therefore a necessity for the consumer electronics sector. In this respect the CEEC are attractive markets for the EC consumer electronics industry because of their proximity and their consumer potential.

Harmonisation of rules of origin

Consumer electronics companies based in the Community showed a potential interest in sourcing components in the CEEC. Further cumulation possibilities and a harmonisation of the rules of origin would certainly be an incentive to shift sourcing from the Far East but would only become a reality when the quality and continuing availability of the products were guaranteed. At present, most companies are hesitant to source components in the CEEC, though Poland, Hungary and the Czech Republic in particular are beginning to attract interest.

In addition to general differences concerning rules of origin between the agreements, there were certain differences in the electronics sector concerning the processing requirements deemed sufficient to confer origin on non-originating materials. European manufacturers in the electronics sector were hindered by these differences and the following barriers to European trade in the electronics sector were highlighted:

¹ Figures are extracted from 'Panorame of EC Industry 93' and statistical figures from Eurostat.

- customs procedures at the borders of CEEC, specifically Poland, resulted in long waiting periods causing delays and adding to costs;
- high import duty levels in the CEEC on consumer electronics, even for EC originating goods;
- in Poland, import duties on consumer electronics are at present hit by a 6% surcharge tax;
- the administrative burden of keeping track of the origin of all components used in an assembly process was often higher than the possible savings on import duties.

Although some of these barriers concern sectors other than rules of origin it would be helpful both for the Community and the CEEC industry if the substance of the origin rules was brought in line in all agreements.

The no-drawback rule

At present, a substantial percentage of consumer electronic goods manufactured in the Community are still subject to import duties in the CEEC. Although the import duties are lower than those for products from third countries, the difference to be gained through processing in the Community might not outbalance the possible extra costs of manufacturing there rather than in a third country.

A further decrease and the eventual abolition of import duties would create more advantages to use the absence of a no-drawback rule. The situation for the CEEC is different as import duties on consumer electronic products have (with a few exceptions,) already been abolished. The exclusion of the no-drawback rule is a positive influence on developing manufacturing plants in the CEEC as processing under drawback in the CEEC allows the use of duty-free components from third countries.

However, if a no-drawback rule was introduced, import duties would have to be paid on third country parts in the CEEC or on the end-product in the EC. A positive consequence of this would be to encourage the use of CEEC or EC parts.

Extending diagonal cumulation

Extending diagonal cumulation possibilities would facilitate EC manufacturers to source components in CEEC countries, to spread production processes to two or more involved areas or countries and export the end-products to EFTA countries and other CEEC without loss of origin. As 26.3% of EC exports of consumer electronics in 1991 (representing 7.9 billion ECU) went to EFTA countries, it is clear that they are important export markets for EC manufacturers. Furthermore, it is expected that the CEEC will become increasingly important in the near future as export markets for EC manufacturers. This strengthens the importance of a system of European cumulation.

An enlarged system of diagonal cumulation would increase the competitiveness of EC manufacturers through increased possibilities for sourcing of components. An integrated system of diagonal cumulation is expected to have a positive effect on consumer electronics companies located in the area where the system is applied.

Extending diagonal cumulation would increase possibilities for sourcing components and improve market access throughout the preferential trade area. Some companies anticipate a positive effect on employment in the EC due to increased competitiveness, though it is possible that there might be a negative effect on employment in some areas due to the de-localisation of certain components manufacturers towards the CEEC. However, it is considered that an integrated system of diagonal cumulation would contribute more significantly towards a shift of sourcing parts from outside the free trade zone towards the CEEC.

Consequences of introducing full cumulation

No extra benefits were perceived by introducing full cumulation into the EC and EFTA agreements with the CEEC. In addition to the considerable administrative difficulties in establishing a reliable system of full cumulation throughout the EC/EFTA/CEEC zone, full cumulation was considered to favour the continuing use of third country components rather than encouraging the establishment of components manufacturers, possibly in the CEEC.

ANNEX II

TEXTILES

The EC textiles and clothing industry currently employs about 2,4 million¹ people spread over more than 140,000 firms with a total turnover of 160 billion ECU. The different stages of textiles and clothing production are interdependent (textiles chain).

Certain economic factors, such as the development of labour costs, the decrease in transportation costs and currency developments, have contributed to the decline of the traditional textiles and clothing industry in Europe and have favoured, in particular in the clothing industry, an internationalisation of the production process through de-localisation and subcontracting. This has, in turn contributed to the progressive reduction of technical and expertise gaps and to the development of new levels of quality and organisation in low labour cost countries, especially those bordering the Community, which have therefore become more interesting subcontracting parties as well as potential competitors.

It is accepted that the rules of origin for the textiles sector are extremely complex and esoteric. As with other sectors, a 'sufficient transformation' rule applies which means that a product receives the origin of the country where the non-originating material undergoes a sufficient transformation.

Small enterprises, in particular, have difficulty in coping with the complicated legislation and with meeting the necessary requirements enabling a product to be considered as originating. Exasperated by the cost of keeping track of all materials used and of operations carried out, many operators in the textiles sector do not even attempt to benefit from the preferential tariff arrangements. To many operators the rules of origin and the different cumulation provisions are almost unknown and it is suggested that their implementation by customs administrations causes difficulties.

The existing cumulation provisions whereby products can only be considered as originating within the context of one particular agreement have repercussions for the textiles sector, due to the increasing demand to de-localise certain processing operations.

Harmonisation of rules of origin

Contrary to other sectors, the rules of origin in the textiles sector are already rather similar in all agreements concerned. The remaining differences should be brought into line for the same kinds of working or processing. In the cases where general tolerances to the processing requirements are really necessary, they should be identical and related to the same unit of measurement.

¹ Employment in the EFTA countries was estimated at about 150,000 in 1992.

The no-drawback rule

At first sight, the lack of a no-drawback rule in the agreements with the CEEC might have less impact on the textiles sector than on other industrial sectors. EC import duties are comparatively low on raw materials and semi-finished products and the successive transformations which the imported materials have to undergo to obtain origin would normally reduce any advantage considerably. Nevertheless, it is worth noting that the textiles industry is extremely price and cost sensitive. Therefore, in order to avoid circumvention of customs duties by exploiting the absence of the no-drawback rule which might lead to de-localisations from the Community and the EFTA countries to the CEEC, the introduction of no-drawback provisions into all agreements should be considered.

Extending diagonal cumulation

A simple and harmonised European cumulation system would undoubtedly contribute to the awareness and correct application of the rules both among operators and customs authorities, especially if that system was accompanied by adequate measures to reinforce control, communication and co-operation between the different countries involved, in particular the CEEC.

Under a European system of diagonal cumulation certain manufacturers and clothing manufacturers would get access to cheaper semi-manufactured products. Although there are positive aspects with regard to the introduction of such a system to the textiles sector, there are also negative aspects and areas of great uncertainty, notably with regard to employment effects.

Extending diagonal cumulation would have an impact in a number of ways on the structure and competitiveness of the EU textiles and clothing industries. On the one hand the availability of low cost semi-manufactured products from the CEECs would increase the competitiveness of EU clothing producers and thereby slow down the de-localisation of clothing production. On the other it would lead to a general increase in the importation of semi-manufactured products from third countries. This could lead to a reduction in the production of semi-manufactured products in the EU, and to possible further de-industrialisation and loss of employment in the subsectors active in the early stages of the textile production chain.

While a more competitive clothing and textile finishing industry might emerge in the CEECs, there could be a detrimental impact on the corresponding industries in the EU. Therefore, clothing manufacturers and textile finishers in the EU would tend to favour integration of European cumulation provisions while other sectors of the industry would be more hesitant.

Generally, the textiles and clothing industry would therefore be rather hesitant to an integration of the European cumulation provisions, whereas, certain clothing manufacturers and textiles finishers in particular, would be in favour.

Consequences of introducing full cumulation

It is considered that any extension of the existing cumulation possibilities in EC/EFTA/CEEC trade might have negative consequences for certain parts of the EC textiles and clothing industries. The immediate introduction of full cumulation would aggravate the major difficulties encountered in this sector. Introducing full cumulation at this stage would increase the overall competitiveness of CEEC industries at the expense of the corresponding industries in the Community and increase the content of third country materials in originating finished products. It would therefore be appropriate to await the impact of other major changes, such as the conclusions of the GATT Uruguay Round, on the textiles sector before considering whether there would be any benefits in introducing full cumulation.

Consequently, the first stage towards extending the existing cumulation provisions in the textiles sector should not be to introduce full cumulation to the CEEC, but rather to widen the existing diagonal cumulation provisions in the Agreements with the CEEC to cover all the CEEC under one system. It should be noted that the implementation of measures relating to a European cumulation system is without prejudice to the EU's existing commercial defence policy.

ANNEX III

AUTOMOBILES

The European (EC/EFTA/CEEC) automobile sector is the second largest in the world, representing 37% of the world market and employing directly more than 1.8 million people in the supply and manufacturing chain¹.

Though one of the largest consumers of steel, plastics, glass and rubber, resulting in significant trans-frontier trade, the automobile sector in Europe is also characterised by a strong industrial concentration. In the majority of cases, manufacturers and suppliers are located within close proximity of each other and on a limited number of sites. Widespread use of just-in-time delivery methods has developed this tendency further.

Unlike in the CEEC, automobile constructors have little presence in EFTA countries other than in Austria or Sweden. All CEEC are involved in vehicle construction though Poland, Hungary and the Czech Republic have the largest interest.

The level of investment required for production facilities in the automobile industry is such that constructors have been forced into partnerships to make business viable. In addition, the unfavourable economic situation has resulted in considerable efforts being made to improve competitiveness and develop economies of scale.

Constructors have signed association agreements or have set up plants in the CEEC in order to increase penetration in those countries and to benefit from low wage costs and other incentives.

De-localisation is not as feasible for automobile manufacturers as for other economic sectors due to the amount of investment involved. However, there are factors in favour of de-localisation and diversification of sourcing. Automobiles are semi-perishable and require maintenance and replacement parts. The necessary service networks are sensitive to the emergence of locally produced supplies. The effect of customs duties and rules of origin are other factors which might encourage de-localisation, particularly with regard to certain automobile parts.

The major restructuring of the whole of the automobile industry in Europe has emphasised increased productivity. As a result, suppliers have been forced to reduce, or at least maintain, existing price levels and the need to seek alternative sourcing has become apparent. A variation of a few percentage points in the price of a component would effect purchasing decisions due to the volume of orders. The absence or existence of customs duties, together with other incentives such as labour costs would be adequate incentives to switch sourcing of automobile components to other countries. The advantage would increase proportionally to the relative proximity of the supplier. The trade flows of parts between the EC, EFTA and CEEC are still limited but many companies are keenly interested to diversify sourcing in the future and maybe even assembly. In the coming years, there will be a significant redeployment of the automobile and associated industries in Europe.

¹ Figures for 1993

Harmonisation of rules of origin

A comparison of the rules of origin in the agreements showed that as with other sectors, there are certain differences with regard to the processing requirements deemed sufficient to confer origin on non-originating materials. The differences appear to be textual rather than substantial and could be harmonised without great difficulty. This would allow operators to establish a clear basis upon which to calculate preferential origin and allow customs administrations to control the system in a uniform manner.

The no-drawback rule

The absence of a no-drawback rule in the CEEC agreements is of particular concern to EC operators in the automobile sector. Taking into account the future total withdrawal of EC tariff protection for CEEC originating products, the absence of such a rule might create trade distortions. In order for there to be a uniform, equitable application of the Europe Agreements, it is clear that consideration would need to be given towards the inclusion of a no-drawback rule.

Extending diagonal cumulation

The study suggested that within the context of an agreement between two (or more) zones of equal economic development a system of full cumulation appeared to offer the widest range of opportunity for commercial and industrial co-operation. In the context of an agreement between two (or more) zones of unequal economic development, a system of diagonal cumulation accompanied by a no-drawback rule appeared to offer the best solution.

Introducing a system of diagonal cumulation across the EC/EFTA/CEEC zone would permit substantial interpenetration of European operators in the automobile sector. This type of cumulation would reduce the problems faced by the European automobile industry with regard to aggressive competition and the circumvention of existing customs protectionary measures.

One element in favour of a strategy of industrial development in the CEEC would be the flexibility and stability guaranteed by a system of European cumulation.

Consequences of introducing full cumulation

The study pointed to the negative effects of introducing full cumulation into the context of agreements between zones of unequal economic development. Significant parts of the automobile industry would de-localise towards the cheapest labour market. It is also suggested that full cumulation would enable economic operators from outside the zone to avoid, to an extent, the Community's customs tariff by setting up assembly plants in partner countries surrounding the Community.

The effects of full cumulation are more positive in agreements with partners of equal economic development, such as the EEA countries. At a later stage, increased economic cooperation throughout Europe and industrial development in the CEEC would establish a more favourable environment for the introduction of full cumulation.