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Rules of origin in GSP schemes and their impact on Nepal's exports: a case study of tea, carpets, pashmina and handicrafts products

by

D. R. Khanal

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Executive Summary

Rules of origin (ROO) define a condition under which preferential access to the product of an exporting country may be granted. Under the rules, a product must satisfy the fixed originating criteria they lay out. These rules are applied to determine whether particular exported products are eligible for preferential treatment based, for example, on the generalized system of preferences (GSP) when developed countries import the products.

The objective of this study is to find out how preferential rules of origin are applied to Nepalese exports and examine the effects of rules of origin criteria in augmenting carpet, pashmina, handicrafts and tea exports from Nepal to the EU, Japan and the USA under duty free quota free (DFQF) facilities, a special category of preferential non-reciprocal trade treatment granted to least developed countries (LDCs). For implementation of these facilities, so-called “preferential” rules of origin are used.¹

Different forms and schemes of rules of origin are used by WTO member countries to implement the Generalized System of Preferences (GSP) in general and DFQF in particular. The European Free Trade Area (EFTA), European Union (EU) and Japan use the process criterion² (European Union and Japan use a percentage criterion for certain products, such as processed foods, chemicals, and machinery), while those of Australia, Canada, New Zealand, and the United States use the percentage criterion.

Nepal enjoys duty free and quota free (DFQF) preferential treatment from the EU, Japan and the USA. This study assesses the impact of rules of origin criteria on the Nepalese exports of selected commodities to these countries. The commodities included in the study are carpet, pashmina, handicrafts and tea. These commodities compose Nepal’s most crucial exports. Their share in total exports in 2008/09 was about 35 percent. Their role in terms of backward and forward linkage effects in production is also significant due to spill over effects on income and employment.

The study opens with a short review of Nepal's trade policy. It finds that Nepal’s trade policy is highly liberalized. Indeed there are no non-tariff barriers applied to exports, indicating the compliance of Nepal’s trade policy with WTO multilateral trading rules.

The study continues with a brief review of rules of origin and related practices adopted by the EU, Japan and the USA. It finds that the criteria followed by these countries are not exactly the same. On the other hand, despite three quarters of Nepal’s export enjoying preferential market access, utilization is still low either because of the imposition of quotas or the strict rules of origin. Nepal is

¹ Preferential Rules of origin are at the core of every reciprocal preferential trade agreement, bilateral or plurilateral (e.g. SAFTA). However the focus of this study are non-reciprocal (i.e. unilaterally granted) preferential rules of origin which are to be found in many special preferential schemes for LDCs.

² Goods, the production of which involved more than one country, shall be deemed to originate in the country where they underwent their last, substantial, economically justified processing or working in an undertaking equipped for that purpose, resulting in the manufacture of a new product or representing an important stage of manufacture. This basic concept is interpreted as process criterion, percentage criterion, or a combination of these two criteria in determining the country of origin. A detailed discussion on these and related issues is made in Chap IV.

one of the least developed countries (LDCs) deprived of the US DFQF treatment for garment exports after the expiry of the MFA. African countries, on the other hand, enjoy such advantages in the US market.

The methodology of this study focuses on using surveys of manufacturers and traders. However, the study also employs quantitative techniques using primary survey data. in the form of build-up and build-down methods to determine the qualifying level exportable commodities like carpets, pashmina, handicrafts and tea, considering the range under both criteria.

The findings of the study indicate the necessity of reforms in rule of origin criteria as well as verification procedures so as to ensure export benefits under preferential trade agreements to least developed countries like Nepal. The study also finds areas in which internal policy reforms will be required to enhance the incentive structure facing exporters.

Chapter I: Introduction

1.1 Research Problem

Nepal is one of the most liberalized countries in the South Asian region. Both applied tariff rates and openness indicators corroborate this (Khanal, 2008). Despite such a liberalized trade regime, Nepal is increasingly facing the problem of diversification of trade, both in terms of partner countries and commodity diversification. More than two thirds of Nepal's trade is conducted with India. There has been no commodity diversification in trade even in the post-liberalization period that began in the early 1990s. Since 2003-4 there has been a continued deceleration in commodity exports in relation to GDP. The share of commodity exports declined to 7.29 percent of GDP in 2008-9, compared to 10.9 percent of GDP in 2003-4. During this period, exports of several products suffered. For example, jute, historically a major export industry, is on the verge of collapse. After phasing out the Multi-Fiber Agreement (MFA), the garment sector is also facing problems of survival. Ready-made garments were a major export industry, particularly to the United States. At its peak in 2001 it employed 50 thousand workers. By 2006, the number of workers employed fell to 5 thousand (UNDPRC, 2007). Other products like pashmina and woolen carpets which used to be major exports are now dwindling. Although there has been serious effort given to diversifying the export commodity structure by promoting agricultural-based exports, no major breakthrough has taken place so far (MoF, 2008). This also means that in spite of Nepal enjoying duty-free and quota-free facilities from many countries as a least developed country, it has been unable to reap the benefits.

Amidst a fragile or declining base of exports, the vulnerability of the Nepalese economy has increased in the aftermath of the global financial crisis and recession. Inflows of remittances reached about Rs 210 billion in 2008/09 (NRB, 2009). Indeed, the marked rise in remittances contributed to the development of the banking system. Remittances helped increase consumer demand which in turn pushed up imports and led to higher tariff revenue mobilization by the government given the high dependency on international trade based revenue (Khanal, 2009). The global financial crisis, however, adversely affected remittance inflows due to the decline in the outflow of migrant workers. This led to massive rise in the current account deficit and negatively impacted the balance of payments as recent data from Nepal Rastra Bank indicate. They show that both commodity and services exports were also partly affected adversely (Khanal, 2010). Thus the financial crisis and its contagion have indicated that unless production sectors are augmented through development strategies which prioritize industrialization, the vulnerability of LDCs like Nepal might increase further. However, the country's huge export potential must be harnessed as part of this drive toward industrialization. Nepal's rich biodiversity and competitive advantage in some key areas indicates such a possibility (GoN, 204). But for a country like Nepal in its early stage of development, special preferential treatment in global markets will also be crucial. For the same reason, duty free and quota free market access facilities are of special importance for Nepal. This assessment on the effectiveness of DFQF in promoting exports is critically important for Nepal in forming Nepal's position in future trade negotiations.

1.2 Research Questions

- a. Why was there a sharp decline in Nepalese exports to countries other than India since the beginning of the 21st century?
- b. Is the utilization of duty free and quota free market access constrained by Rules of Origin and other related administrative procedures?
- c. Are there differences among the US, Japan and the EU in the application of preferential rules of origin?
- d. What are some possible means to ensure full utilization of DFQF market access facilities by LDCs like Nepal for increasing exports of key products like tea, carpet, pashmina and handicrafts?

1.3 Scope of the Study

- a. Examines the overall trend of exports with a special focus on major commodity exports to countries other than India.
- b. Analyzes the rules of origin applied by the USA, the EU and Japan to Nepal's exports in general and tea, carpets, pashmina and handicrafts in particular.
- c. Estimates the additional cost of preferential rules of origin and related administrative procedures in tea, carpets, pashmina and handicrafts and makes a comparative assessment with non-preferential rules of origin.
- d. Assesses the impact of preferential rules of origin on the export of tea, carpets, pashmina and handicrafts, and
- e. Derives some useful policy recommendations from the point of view of international trade negotiations and sustainable development.

1.4 Structure of the Report

After this introductory chapter, chapter two is devoted to review of the literature. Chapter three concentrates on discussing the trade policies pursued by Nepal especially after 1990. In the same chapter, trends in the major commodity exports are also presented. In chapter four, various forms of rules of origin and their application to Nepal's exports are discussed with a focus on the practices of the EU, Japan and the USA. The same chapter is devoted to examining the rules of origin applied by the EU, Japan and the USA to tea, carpet, pashmina and handicraft products. In the fifth chapter, the results of the survey highlighting the perceptions of entrepreneurs and exporters of the specified products are presented. In the same chapter, the results of the quantitative analysis using the total

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