

How to Strategize ROO Schemes for Korea-Indonesia CEPA*

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Key Word : ROO, Indonesia, FTA, Origin, CEPA

* After an earlier version of this paper was presented in the 8th international conference on business and management research in 2013, the paper herewith is further revised and improved.

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I . Introduction

FTA(Foreign Trade Agreement ; hereinafter 'FTA') can be a solution to expand overseas markets for Korea which has relatively small territory and limited natural resources. So there have been a growing number of bilateral trade agreements as a form of FTA between Korea and other countries. As a result, nine FTA like Korea-Chile FTA, Korea-Singapore FTA, Korea-EFTA FTA, Korea-ASEAN FTA, Korea-India CEPA, Korea-EU FTA, Korea-U.S.A.

FTA, Korea-Peru FTA and Korea-Turkey have been concluded and implemented in 46 countries as of May, 2013.

In addition to these nine FTA, Korea has been negotiating FTA or CEPA(Comprehensive Economic Partnership Agreement)¹⁾ with China and Vietnam and Indonesia.

In the meantime, the ration of FTA portion over world trade volume is also being increased as you've seen in <Table 1>, which means FTA becomes important more and more in world trade.

<Table 1> The ratio of FTA portion over world trade volume

Division		'08	'09	'10	'11	'12
In FTA	Export	548	452	711	1,457	2,044
	Import	492	417	597	1,204	1,666
	Trade Volume	1,040	869	1,308	2,662	3,710
World	Export	4,220	3,635	4,664	5,552	5,479
	Import	4,353	3,231	4,252	5,244	5,196
	Trade Volume	8,573	6,866	8,916	10,796	10,675
Ratio(%)		12.1	12.7	14.7	24.7	34.8

source : FTA Trade Report(July. 2013), Korea Institute of Origin Information.

1) CEPA which is broader than a free trade agreement(FTA), is a tool to attain the ambitious goals of economic cooperations but CEPA has same meaning with FTA, practically.

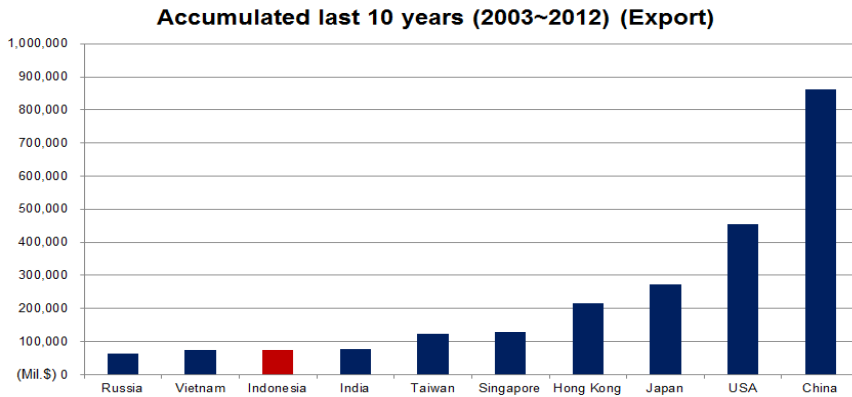
The ROO(Rules of Origin ; hereinafter ‘ROO’) schemes in such FTA agreement includes consumer’s right on products origin and protection of manufacturers and preferential tariff rate(Park, 2013). Thus, one of the key issues in upcoming FTA could be ROO schemes because tax tariff and admission scope of country of origin can be varied depending upon ROO schemes which will also affect the activities like export, foreign direct investment in firms which conduct international business. The difference of ROO schemes in each FTA also results in spaghetti bowl effect²⁾ which brings about difficulty in using FTA properly since exporter and importer may confuse in whether the concerned products for trade can have tax reduction benefit or not. This means the optimization of ROO design should be highly required.

Meanwhile, Korea–Indonesia celebrate the 40th anniversary of diplomatic ties in 2013 and pursue a strategic partnership both locally and globally for the 40th anniversary of the two country’s diplomatic ties. In 2011 Indonesian government inked U\$ 400 million pact for purchasing 16 T-50s to mark the first export of the trainer jet in Korea. Their total trade volume amounted to U\$ 29.6 billion in 2012. Indonesia remains 8th partner in export and 10th partner in import in terms of Korea. Among Asian countries, Indonesia becomes of great importance in trade with Korea more and more as depicted in <Figure 1> and <Figure 2>.

So this paper suggests how to strategize ROO schemes for Korea–Indonesia CEPA under negotiation currently since more activation of bilateral trade in FTA could be possible depending upon the design of ROO schemes.

2) When a country concludes FTA agreement with many countries, ROO may differ depending on countries so the utilization of FTA can be reduced because of complication like noodles in spaghetti bowl.

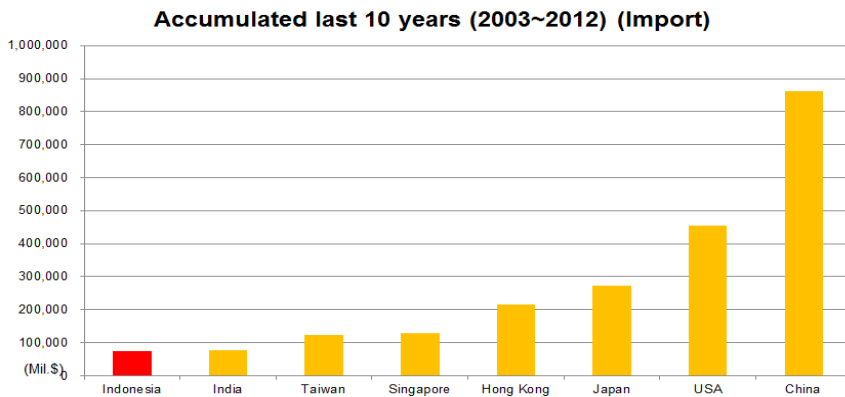
〈Figure 1〉 The status of export in terms of Korea



source : Authors who refer to the Korea Customs statistical data.

The composition of this paper is as follows. Chapter 2 includes a review of the existing literature on ROO in FDI. Chapter 3 introduces the definition of origin and three key issues to determine ROO. Chapter 4 contains strategies for design of ROO schemes. In Chapter 5 this study summarizes how to design ROO schemes in Korea-Indonesia FTA and suggest implication along with limitations.

〈Figure 2〉 The status of import in terms of Korea



source : Authors who refer to the Korea Customs statistical data.

II. Literature Review

There was multiple previous studies regarding ROO in FTA.

First, the objective of papers was related to the issues of ROO regulation. Park(2013) suggested the ways of improving the issues related to ROO in Korea Foreign Trade Act. Kim and Jung(2010) concluded application of law related to ROO was difficult since concerned laws like custom law, foreign trade law were different with each other. Lee and Kwon(2011) explored the cases of decision issues on ROO in FTA.

Second, there were studies concerning ROO with regards to countries which concluded or are negotiating FTA with Korea. Lee and Oh(2013) studied ROO regulations for agricultural and marine goods related to Korea–China FTA. Cheong(2012) explained the issues and economic impacts on Korea–Vietnam FTA. Cheong and Cho(2008) summarized the impact of Korea–China FTA on Korean industry. Kim and Jeong(2013) made comparison in ROO between Korea, U.S.A. and EU.

Third, there were papers regarding the determinants of ROO. Jon and Cho(2012) suggested how to countermeasure about origin verification of Korea–EU FTA. Lee and Kim(2008) studied the criteria for determining the country of origin in the FTA between Korea and India. The suggested criteria was tariff rates, trade balance of payment, import market share. Kim and Cho(2012) summarized the determinants of ROO in FTA like “trade specialization index”, “change in instances of import and export”, and “instances of import and export”. Jung and Lee(2011) made comparative analysis in terms of “change of tariff classification”, “value added rule”, and specific process rule “to determine origin under Korea’s FTA with USA, EU and ASEAN.

Lastly, there were studies concerning other subjects related to ROO. Lee and Kwon(2011) examined the cases on the breach of ROO in FTAs. Yoon et al.(2010) suggested strategies to upgrade international competitiveness of trade exhibition industry in Northeast Asia region by making use of ROO in

Korea-China-Japan FTA. Cho and Ahn(2011) analyzed ROO in Korean FTAs and domestic firms' use of FTAs. Takauchi(2010) studied the effects of strategic subsidies under FTA with ROO. But there was little study on ROO in Korea-Indonesia FTA yet. So this paper has a meaningful contribution in academic area as well as practical fields.

III. The Definition and Three Key Issues to Determine ROO

1. The Definition of Origin and ROO

The definition of origin is the “economic” nationality of goods traded in commerce. It is necessary to determine the nationality and tariff classification of goods in order to be able to determine the duties and equivalent charges or any customs restrictions or obligations applicable to them. Certificate of origin(CO) refer to the document that proves country of the good produced or the originating status of the good in question or document providing that the exported god was grown, raised, manufactured or processed in Korea.

The General Agreement on Tariffs and Trade(GATT) defines ROO as “those laws, regulations and administrative determinants of general application applied by any member to determine the country of origin or goods, provided such ROO are not related to contractual or autonomous trade regime leading to the granting of tariff preferences going beyond the application of paragraph 1 of article 1 of GATT 1994”. There are two kinds of origin, preferential and non-preferential origin and the customs treatment of goods at importation is determined by the origin they have.

1) Preferential ROO³⁾

3) OECD, “The Relationship between Regional Trade Agreements and Multilateral Trading System : Rules of Origin,” TD-TC/WP(2002)33/FINAL, Working Party of **the**

ROO are contained in all kinds of FTA providing for preferential treatment among members, namely free trade areas and customs unions. Such preferential ROO are aimed at distinguishing products that are entitled to preferential tariff treatment from products that are not. They are an essential component of FTA. These FTAs use ROO to avoid free riding of their regional preferences (trade deflection) by stopping third parties from shipping to the FTA entry with the lowest external tariff for a given product. They are less important for accomplished customs unions, which have a common external tariff but nevertheless keep their relevance for the administration of external trade preferences such as GSP (Generalized System of Preferences) schemes or preferential agreements concluded with third countries. For instance, the existence of a common EU external tariff and a common EU external policy makes the choice between different EU entry points irrelevant. EU preferential rules are thus used to distinguish between goods from various non-EU origins and not between EU and third country origins.

2) Non-Preferential ROO⁴⁾

Most FTAs leave non-preferential rules outside their coverage. Each FTA member country maintains its domestic system of ROO for administering anti-dumping and countervailing duties, marking requirements, or quantitative restrictions and quotas. The only RTA that has common non-preferential ROO in addition to its preferential rules, is the EU which, as a customs union, has a common external trade policy. Although case is unique, it is worth mentioning as the only regional ROO system indirectly comparable to the systems already operating at the national level in WTO members and to the WTO harmonized provisions, once they are finally

Trade Committee, 2002. 7. p. 7.

4) OECD, *op. cit.*, p. 8.

adopted.

2. Three Key Issues to Determine ROO

1) General Rules Related to Criteria to Determine ROO

The basic framework of ROO schemes in FTA agreement consist of “General rules” which will be applied to total products or to specific products in common manner and “Product specific rules” which will be only applied to the concerned specific products.

General rules may consist of two ways to fix ROO ; “wholly produced(obtained)”, “substantial transformation”, actual change of HS code and supplementary ROO schemes.

(1) Wholly Produced(obtained)

To fix ROO, “Wholly produced” rule can be applied to the items produced in one country. Generally, agricultural items or products related to mining industry may belong to such items.

(2) Substantial Transformation⁵⁾

If items will be produced in more than two countries, “substantial transformation” rule can be applied to fix ROO but devising methods for determining sufficient processing (or substantial transformation) has turned out to be very complex in all existing preferential trade agreements because the Harmonized System was not designed to define the origin of goods. Three criteria are used to determine whether sufficient transformation has taken place in activities requiring processing.

First criteria is a change of tariff classification(CTC) meaning that the final product and its imported components should not belong to the same tariff

5) Olivier Cadot, Jaime de Melo, “Why OECD countries Should Reform Rules of Origin”, *The World Bank Research Observer*, Vol.23(1), 2008, pp. 81~82.

classification (in other words, that the local processing should be substantial enough to induce a change of tariff classification). CTC may have three kinds ; change of chapter(CC) which will be changed in two digit, change of tariff heading(CTH) which will be changed in four digit and change of tariff subheading(CTSH) which will be changed in 6 digit.

Second criteria is a critical threshold for value added, in short, a value content(VC) rule which will break up domestic or region value content(RVC), imported content(MC) and value content(VC).

Third criteria is a specific manufacturing process (a so called “technical requirement”) which will be applied to fabric or clothes items produced by specific manufacturing process.

In the meantime, many FTA agreement contains product specific rule(PSR) in annex part. In PSR, criteria determinants can be based on CTC, VC and technical requirement.

As Krishna(2006) points out, when analyzing ROO ,the devil is in the details because the complexity of ROO is what provides an opportunity for special interest to influence their design and administration. While many facets of ROO have been explored, rigorous empirical study of their effects has been hampered by two difficulties, one relating to data on utilization rates, the other to measurement of the rules’ restrictiveness.

First, data on preference utilization have been made freely available to the public only recently for the United States but not yet for the European Union.

Second, because ROO are a set of complex, heterogeneous legal rules, it has proved difficult to develop a reliable measure of their restrictiveness to serve as a synthetic indicator(much like effective rates of protection are a synthetic indicator of the restrictiveness of a country’s trade regime).

(3) The Supplementary Rules to Determine ROO

These rules usually include five components. First, a *de minimis* (or tolerance) criterion that stipulates the maximum percentage of

non-originating materials that can be used without affecting the origin of the final product. Second, A cumulation rule, Third, a provision on whether “roll-up” applies. Fourth, the status of duty drawbacks. Fifth, the applicable certification method.

2) Origin Proof System⁶⁾

There would be three kinds of system.

First, the competent customs authority or other authorized bodies issue certificates of origin after confirming origin of goods in question pursuant to modality and procedures stipulated in the FTA agreement. This system is called as authority-issuance system.

Second, the exporter confirm the country of origin of goods in question pursuant to the modality and procedures stipulated in the FTA agreement and declares by signing. This system is called as self-issuance system.

Third, authority-issuance system and self-issuance system can be combined as the results of negotiation of FTA agreement.

3) Origin Verification System⁷⁾

Country of origin is verified by targeting the domestic importer, exporter, producer, issuing-authority of the origin supporting documents as well as the exporter or producer of the FTA contracting party in order to confirm the origin of the exported/imported goods and to verify whether or not preferential tariff treatment was duly granted to the goods. Origin verification is conducted after categorizing them into export verification and import verification and different modality for origin verification is applied under each FTA.

6) http://www.customs.go.kr/kcshome/main/content/ContentView.do?contentId=CONTENT_ID_00002334&layoutMenuNo=23242

7) http://www.customs.go.kr/kcshome/main/content/ContentView.do?contentId=CONTENT_ID_00002337&layoutMenuNo=23247

There are three kinds of modalities.

First, there is direct verification system(American style) conducted by customs in importing party targeting the overseas exporter.

Second, there is indirect verification system(European style) where customs in the exporting country conducted origin verification on domestic exporter as requested by the importing country. Officials from the importing country's competent authority can join the verification as an observer.

Third, there is combination of direct and indirect verification system(Asian style).

IV. Strategies for Design of ROO Schemes in Korea–Indonesia CEPA

The chapter three in this paper explains three key issues in ROO schemes. So what will be the proper strategies to design of ROO schemes in upcoming Korea–Indonesia FTA for better utilization and activating bilateral trade? In other words, how to design ROO schemes in terms of origin proof system, origin verification system and justified criteria to determine ROO?

First, the FTA partner country will apply preferential tariff treatment to goods, provided that the goods fulfill preference criterion set out in the FTA agreement and CO for the goods stipulated in the FTA agreement is prepared as well. So either self–issued CO or authority like custom authority issued CO will be required. In case of upcoming Korea–Indonesia FTA, self–issued origin proof system can be more preferable because the FTAs which have adopted self–issued origin proof system like Korea–Chile, Korea–EU, Korea–USA show better utilization ratio of FTA as shown in <Table 2>. The way of completing self–issuing CO in Korea–Chile FTA or Korea–EU FTA as example cases may be shown in <Table 3>.

<Table 2> The Status of issuing modality CO and utilization ratio

	Chile	ASEAN	EU	USA
Issuing Modality C/O	Self-Issued	Authority-Issued	Self-Issued	Self-Issued
Issuer	Exporter	Government Authority	Approved Exporter	Exporter, Producer, Importer
Form of Certificate	Uniform Certificate	AK Form	Invoice Declaration	-
Validity Period	2	0.5	1	4
Utilization Ex:Im('12)	75.2 : 97.9	37.7 : 73.8	81.4 : 66.8	68.9 : 61.0

source : FTA Trade Report(July, 2013), Korea Institute of Origin Information.

<Table 3> The way of completing self-issuing CO in Korea-Chile & Korea-EU FTA

<p><input type="checkbox"/> Korea-Chile FTA</p> <p>[Producer] Origin Notification: If exporter and producer are different, pursuant to Korea-Chile FTA, producers shall complete Origin Notification and provide this to the exporter for the good fulfilling its Rules of Origin under the Agreement (Form No. 2 to Attachment 4 of Notification)</p> <p>[Producer] Written representation: If producer is unable to receive Origin Notification under the reasons such as layoffs or closure of the business, written representation can replace the Origin Notification (Form No. 3 to Attachment 4 of Notification)</p> <p>[Exporter] Certificate of Origin: Exporters shall complete the C/O in the format recommended in the Agreement based on the written representation or Origin Notification. Signature of the signatory shall be stamped to issue the C/O</p> <p><input type="checkbox"/> Korea-EU FTA</p> <p>There is no recommended form under Korea-EU FTA, but the Text of Origin</p>

Declaration shall be written on invoice, delivery note and/or other commercial documents.

Text of the Origin Declaration
 The exporter of the products covered by this document (Customs Authorization No) declares that, except where otherwise clearly indicated, these products are of preferential origin.

Approved exporters are entitled to self-issue C/Os to gain preferential tariff treatment under Korea-EU FTA provided that they export goods of its value above 6,000 euros – for goods under the value of 6,000 euros, the exporter is entitled to self-issue the C/Os without the Approved Exporter Status.

source : FTA Portal Information Service(Korea Customs Internet Home-Page).

Self-issuance system enhances more use of FTA, more convenient and more efficient than authority-issuance system. So unlike Korea-ASEAN FTA, Korea-Indonesia FTA can be considered to design self-issuance system. The details of issuing modality can be organized after referring to the cases of Korea-Chile or Korea- EU.

Second, origin verification system will be required to prevent omission of custom duty by fake CO and detouring importing goods thru third countries. The status of origin verification modality is presented in <Table 4>.

<Table 4> The status of origin verification modality

Free Trade Agreement	Indirect Verification	Direct Verification	Reply Period
Korea-Chile	-	Verification questionnaire or letter, Verification visit	-
Korea-Singapore (In sequence)	To send a request for provision of cost and production statement and information to exporter or producer through Customs in the exporting country.	Verification visit after the indirect certification conducted.	-

Free Trade Agreement	Indirect Verification	Direct Verification	Reply Period
Korea-EFTA	To send a request for origin verification to Customs of the exporting country and to participate in the verification procedures as an observer	-	10 months
Korea-ASEAN (In sequence)	To send a request for origin verification to the issuing authority of the exporting country	Verification visit after the indirect certification conducted.	2 months
Korea-India (In sequence)	To send a request for origin verification to the issuing authority of the exporting country	Verification letter or Verification visit after the indirect certification conducted.	3 months
Korea-EU	To send a request for origin verification to Customs of the exporting country and to participate in the verification process as an observer.	-	10 months
Korea-Peru	To send a written request for provision of additional information to exporter or producer through the competent authority of the exporting country	Verification visit with officials from a competent authority	150 days
Korea-US	Applying indirect verification modality (on textileproducts only)	Verification questionnaire or letter, Verification visit	Textile: 6months

source : FTA Portal Information Service(Korea Customs Internet Home-Page).

The modality of origin verification in FTAs of Korea-Asian countries like Singapore, ASEAN, India is based on combination of indirect verification and direct verification and the relationship between utilization of FTA and origin verification system seems to be not high.

Indirect system may be more convenient whereas direct verification can be also required to prevent fake CO. So modality of origin verification in

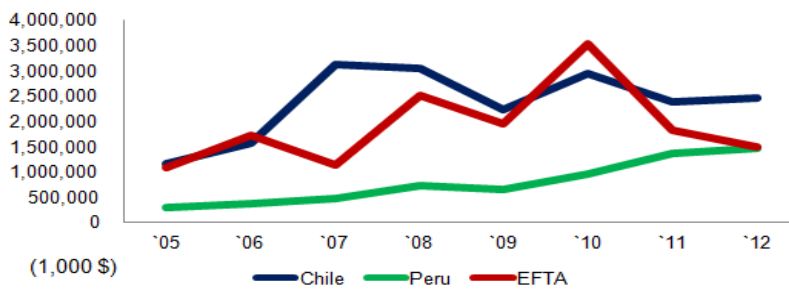
Korea-Indonesia FTA can be designed based on combination system because existing FTA agreements with other Asian countries which have similar trading structures are also based on combination system. Taking combination modality can also minimize spaghetti bowl effect.

〈Table 5〉 Korea FTA utilization in export by products

MTI Classification	ASEAN	EU	Chile	USA
agricultural & forest & marineproducts	18.7	53.7	32.3	52.5
Mineral product	52.3	67.9	98.3	83.7
chemical industry manufactures	56.3	74.6	77	71
articles of plastic rubber or leather	23.8	90.4	86.5	82.9
textile & apparel	12.7	87	60.8	71.4
Living-ware	8.1	86	15.4	69.7
articles of iron or steel & metals	73.3	67.1	60.7	77.7
machinery	28.1	89.8	82.5	81.6
electrical articles & electronic articles	7.5	74.9	67.1	62.3
Miscellaneous articles/sundries	9.2	75	56.6	59.3

source : Authors who refer to the KITA statistical data.

〈Figure 3〉 The status of trade after FTA



source : Authors who refer to the Korea Customs statistical data.

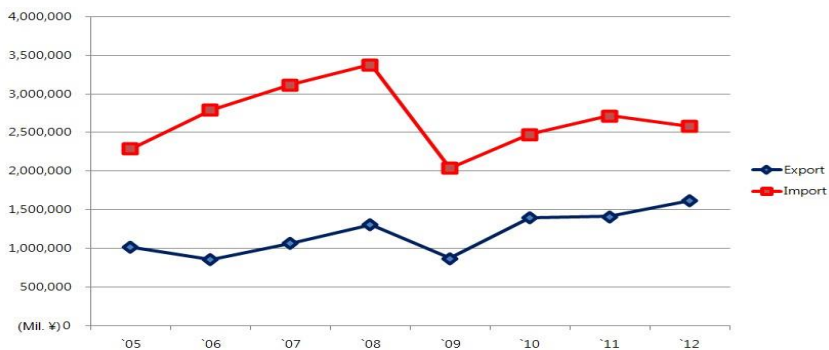
Third, in consideration of utilization of FTA, export increase after implementing FTA, similar type of trading structure with Indonesia in terms of products like mineral product & chemicals, Korea-Chile FTA case are one of most successful and referring case. So this paper examines criteria to determine origin in Korea-Chile FTA which implements since 2004.

〈Table 6〉 The criteria of Korea-Chile FTA

Criterion ; - Wholly obtained - Substantially transformation CTC (change in tariff classification) + VC + SP Goods which are produced in more than two countries ; CTC + VC * 8% De minimis can be also applied.

Meanwhile, Japan-Indonesia FTA was concluded in 2007 and FTA effects take place in nice manner so this paper also examines criteria to determine origin in Japan-Indonesia FTA.

〈Figure 4〉 The Status of Export & Import in Japan-Indonesia FTA



source : Authors refer to the Korea Customs statistical data.

〈Table 7〉 The criteria of Japan-Indonesia FTA

<p>Criterion ;</p> <ul style="list-style-type: none"> - Wholly obtained product - Substantially transformation <p>CTC (change in tariff classification) + VC (Value Content) + SP (specific process)</p> <p>Goods which are produced in more than two countries ; CTC + VC</p> <p>* No De minimis applied.</p>
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After considering two cases, the criteria of Korea-Indonesia FTA under negotiation can be suggested as per in 〈Table 8〉.

〈Table 8〉 The suggested criteria to determine origin for Korea-Indonesia FTA

<p>Criterion ;</p> <ul style="list-style-type: none"> - Wholly obtained - Substantially transformation <p>CTC (change in tariff classification) + VC, mainly</p> <p>Goods which are produced in more than two countries ; CTC + VC</p> <p>* some % of De minimis can be also applied.</p>

〈Table 9〉 Top 10 Trading Items between Korea and Indonesia

Export to Indonesia	U\$(Mil)	%	Import from Indonesia	U\$(Mil)	%
Diesel	3,827	27	Natural gas	5,342	34
Gasoline	1,623	12	Soft coal	3,142	20
Knitted goods	666	5	Crude oil	1,778	11
Plastic resin	603	4	Natural rubber	481	3
Hot rolled steel sheets	515	4	Copper	398	3
Cold rolled steel sheets	357	3	Heavy oil	373	3
Synthetic rubber	269	2	Pulp	311	2
Vehicles	164	1	Other petroils	198	1
Color TV	139	1	Clothes	190	1
Galvanized steel sheet	137	1	Soy bean products	158	1

Subtotal	8,305	60	Subtotal	12,375	79
Total	13,955	100	Total	15,676	100

source : Authors who refer to the KITA statistical data.

In addition to such criteria, the number of products stipulated in PSR should be minimized and applied similar manner to avoid complexity of deciding origin. For your reference, <Table 9> shows top 10 trading items in terms of export & import between Korea and Indonesia.

V. Conclusion

Korea is trying to conclude FTAs as much as possible to expand playing grounds for Korean firms. One of the key issues in FTA is how to design ROO in the agreement because the utilization ratio of FTA and effectiveness may differ depending upon the details of ROO schemes. Now Korean government is about to conclude FTA agreement with Indonesia which is one of crucial trading partners in Asian countries so the objective of this paper is to suggest how to design ROO schemes properly in such upcoming FTA agreement since more activation of trade and more utilization of FTA can be depend on the details of ROO schemes.

As a result, this paper suggests well-design of ROO schemes as follows ; First, self-issuance origin proof system can be considered because authority-issuance origin proof system may reduce the utilization ratio of FTA.

Second, combination of indirect and direct verification system in terms of origin verification system will be more preferable because this will be more fitting to Asian countries as considering trading environments and characteristics of Asian market.

Third, criteria to determine origin can be based on wholly obtained plus substantial transformation system which contains CTC plus VC along with some percentage of *de minimis*. In addition to this, the number of products stipulated in PSR should be minimized and applied similar manner to avoid complexity of deciding origin.

Meanwhile, this paper has the following limitations. First, the research method of this paper is mainly based on literature research and case study methodology so future study based on empirical study will be required. Second, other factors besides ROO may affect the effectiveness of FTAs but this study only handles factor of ROO so further study exploring other factors may be also required in the near future.

Anyway, this paper expects some contribution in terms of more activation of Korea–Indonesia FTA after concluding and implementation in the near future.

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ABSTRACT

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