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Free trade across the European Continent

The Pan-European Cumulation System effectively creates a Pan European free trade zone for industrial goods

By RONALD STEWART-BROWN

'he Pan-European Cumulation System

The European Union, the four European Free Trade Association countries and ten Central and Eastern European Countries are linked by a complex network of around 60 bilateral and multilateral free trade agreements (FTAs). These FTAs have led directly to the almost complete elimination of tariffs and quotas on trade in industrial goods within the free-trade areas they created.

However, these many different, intersecting free-trade areas did not add up to one single continent-wide free-trade area. Product coverage varied and rules of origin were in many cases incompatible. Within any one free-trade area, goods with significant material or component content from elsewhere within Europe could be denied duty-free status. Goods would not necessarily cross duty-free from one free-trade area to another.

In order to remove these impediments to duty-free trade in industrial goods across the European continent the EU, the four EFTA countries and the ten CEECs decided to amend their various FTAs by substituting one common set of rules of origin for those they originally contained. Value could thus be cumulated between different European countries without prejudicing the duty-free status of end products.

The Pan-European Cumulation System

Trade Agreements in Europe

Under the European Economic Area Agreement of 1992 three of the EFTA countries, Norway, Iceland and Liechtenstein, form an integral extension of the EU's internal market, participating in its free movement of goods, persons, services and capital, and accepting the EU's *acquis communautaire* in relation thereto. They each retain full national control of their agriculture and fisheries and, as they are not part of the EU customs union, of their trade relations with third countries.

In 1999 the fourth EFTA member, Switzerland, added to its 1972 FTA with the then EEC seven new bilateral agreements with the EU covering technical barriers to trade, free movement of persons, agriculture, civil aviation, overland transport, public procurement and research. But service sectors such as banking and insurance are excluded from these arrangements 1.

Soon after their emergence from Communism, Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia each signed FTAs with the EU. Under these FTAs most industrial trade between the EU and the CEECs is now duty-free.

Later each of these ten CEECs signed association agreements, also known as Europe Agreements, with the EU to prepare them for EU membership. These agreements cover services, rights of establishment, capital

(PECS), as this radically innovative scheme is widely known, was introduced in 1997. Its result has been the effective creation of a Pan-European free trade zone in industrial goods. Turkey, which had been in customs union with the EU since 1996, joined the PECS in 1999.

The scope and effect of the PECS régime are enormous. For each of its thirty participating countries trade covered by the PECS is a very significant portion of its total trade. **Together the PECS countries are responsible for 42 per cent of world trade, have a combined GDP of around US$ 8 trillion and an aggregate population of 554 million**.

and movement of persons as well as goods. So far they have had little practical trade significance beyond industrial goods.

During the 1990s the non-EU European countries also signed a comprehensive network of FTAs amongst themselves, although some gaps remain. Like the CEEC - EU FTAs, these FTAs are primarily concerned with trade in industrial goods. Most are bilateral, but the free-trade area of the 1993 Central European Free Trade Agreement now encompasses seven of the CEECs: Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia.

Rules of Origin

Countries form free-trade areas to enhance trade in goods "originating" amongst themselves. They each retain control of their trade policies towards the rest of the world.

Within any free-trade area duty-free trade must be restricted to goods "originating" within it**. Rules of origin therefore lie at the heart of every FTA**. In their narrowest form they could exclude goods containing any third country content. In practice, however, FTAs often permit quite high third country content levels.

Rules of origin in Europe fall into three main categories:-

Percentage rules: A product is considered originating if the cost of materials and components imported from outside a free-trade area does not exceed a specified percentage of its ex-works price.

Sufficient transformation: A product is considered to be "sufficiently transformed", and therefore originating, if its tariff heading (a four digit code) under the Harmonised System of the World Customs Organisation is different from those of its imported contents.

The PECS gives any product (including components and materials) considered to have originated in one country within the PECS zone originating status in every other country within the PECS zone. Such products **can therefore be traded duty-free** anywhere within the PECS zone.

The PECS also gives manufacturers great sourcing flexibility. In effect most manufacturers in the PECS zone have as much freedom as they could wish to source components and materials from anywhere, both inside and outside the PECS zone, without risking losing duty-free status on trade within the PECS zone 3.

Implications for the UK

If the UK decided on complete withdrawal from the EU it would undoubtedly be able to negotiate a comprehensive FTA with the remainder of the EU incorporating the PECS rules of origin. Most industrial trade between the UK and the EU would thus remain duty-free.

As an added bonus, the UK would immediately be free to negotiate its own comprehensive FTAs, incorporating the PECS rules of origin, with the EFTA countries, the CEECs and Turkey. Such FTAs would not

Processing requirements: A product is considered originating if specified minimum processing operations have been carried out within the exporting country.

PECS Rules of Origin

Every individual product, as defined by its tariff heading, has a prescribed rule of origin under the PECS. These rules vary considerably, as illustrated by the examples below:-

	Product groups	General rule of or
1	Food	Maximum 10% im
2	Books; glass products; iron and steel products; jewellery; tools; toys	Sufficient transfor
3	Clothing	Manufacture from fabric)
4	Photographic, medical and surgical equipment	Sufficient transfor maximum 40% im OR maximum 30 content
5	Aircraft; boats; furniture; ships	Sufficient transfor maximum 40% im
6	Cars; clocks; locomotives; musical instruments; trucks; watches	Maximum 40% im

need to be restricted to industrial goods, as they are at present through the EU, but could also include services, public procurement and investment.

Notes:

(1) The Switzerland-EU agreement on technical barriers to trade provided for EU recognition of Swiss standards for most industrial products. The Swiss government estimated that the previous cost for Swiss industry of having to comply with EU industrial standards had been 0.5 - 1.0 per cent of the total cost of goods affected by them.

(2) In the table above x% imported content means the aggregate cost of components and materials imported from outside the PECS zone is x% of the ex-works price of the end product.

(3) For example, a Polish car manufacturer may sell a car duty free anywhere within the PECS zone provided that materials and components originating outside the PECS zone do not account for more than 40 per cent of its ex-works price. Of the remaining 60 per cent half might be value added in Poland and half might be components with originating status in Poland (i.e. anywhere within the PECS zone). 40 per cent of the cost of these components might in turn be accounted for by materials and sub-components imported from outside the PECS zone. In this case the aggregate cost of materials, components and sub-components imported from outside the PECS zone would represent 52 per cent of the car's ex-works price (40% + ½ x 60% x 40%).

(4) Principal sources for this note are EFTA, the WTO, HM Customs and Excise and articles by Philippe G. Nell, Head of the Swiss Delegation for the PECS negotiations. Other background is given in Global Britain Briefing Notes No 5, ("The World Trade Organisation"), No 8, ("The Mexico-EU Free Trade Agreement") and No 10, ("The Mexico-EU Free Trade Agreement points the way").