The Takeaway
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Harnessing Regional Trade Agreements as Development Policy Instruments

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Countries enter regional trade agreements (RTAs) for many reasons including, but not limited to, promoting international trade and investment, protecting intellectual property rights, and strengthening political ties. There are currently 356 RTAs in force.[1] RTAs vary by geography, signatories, product coverage, and provisions. Therefore, it's not surprising that some trade agreements induce more trade than others. In a recently published paper, we confirm that the effect on trade varies significantly across RTAs and even more for specific products, like apparel.[2] Our research also illustrates how RTAs can be used as effective development policy instruments to create jobs and address the root causes of migration.

One critical factor determining the trade-creating potential of RTAs is the set of rules that determine what qualifies for RTA

WHAT'S THE TAKEAWAY?

RTAs are proliferating and expanding coverage beyond market access.

RTAs can be effective policy instruments to create jobs and address the root causes of migration.

The change in trade after an RTA varies significantly across RTAs and even more for specific products, like apparel.

RTAs often include restrictive rules of origin clauses for apparel that are associated with less apparel trade.

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benefits. These rules are called the rules of origin (RoOs). To qualify for RTA benefits, the RoOs require that a good must be "substantially transformed" within the RTA region. "Substantial transformation" is then defined in several ways, including changes in tariff classification, value content requirements, or technical transformation in the production process. RTAs occasionally require that qualifying products do not use inputs sourced from non-member countries to avoid "tariff jumping"—an attempt by a non-member country (e.g., China) to set up production in one member country (e.g., Mexico) to export to another (e.g., USA).

APPAREL INDUSTRY CAN DRIVE JOB CREATION AND ECONOMIC DEVELOPMENT

Rules of origin are especially important for apparel because apparel is politically sensitive. To begin with, apparel trade is significant. For instance, U.S. exports and imports totaled about US$ 6 billion and US$ 82 billion in 2021, respectively.[3] Because apparel trade is politically sensitive, it faces significant tariffs and other barriers including safeguards and quota restrictions (e.g., the Multifiber Arrangement (MFA)). Even after the end of the MFA in 2005, China and the United States negotiated and signed a memorandum of understanding as per the safeguard provision of China's WTO accession agreement. The agreement put quota limits on textile and apparel imports from China between 2006 and 2008. Additionally, RTAs often have apparel-specific RoOs that are more restrictive and binding than RoOs in other industries. In comparison with furniture, which is similar in many other ways to apparel, apparel products often face stricter conditions such as a change in a chapter, exclusion of certain inputs, technical transformation, and joint application of multiple criteria.

Restricting apparel trade has implications for developing countries that would otherwise benefit from apparel exports. Apparel production draws workers from agriculture, informality, and unemployment. It is "labor-intensive" (less-skilled) and requires lower start-up costs. It also pays higher wages than other domestic alternatives, hires more female workers than other sectors, and could help mend the gender wage gap.[4,5] As such, expanding apparel exports could also reduce migration flows. The current U.S. administration has recognized the importance of creating economic opportunities to address the migration issue. On July 29, 2021, Vice President Kamala Harris released a cover letter[6] describing the U.S. Strategy for Addressing the Root Causes of Migration in Central America[7] that focuses on private-sector investment in Central America. Since exports are associated with economic growth,[8] trade should be a key part of U.S. development policy for Central America.

WHILE RTAs PROMOTE TRADE, RESTRICTIVE RoOs UNDERMINE TRADE

RTAs are found to have large and positive trade-promoting effects. Between 1988 and 2019, the estimates indicate about 58, 67, and 96 percent increases in total, apparel, and furniture trade, respectively. The apparel estimates, however, vary more than the estimates for total and furniture trade. This feature highlights the complexity and wide variation of apparel-specific provisions in the RTAs.

To showcase the policy relevance of apparel RoOs, consider the Dominican Republic Central American Free Trade Agreement (CAFTA-DR). CAFTA-DR became effective in El Salvador, Guatemala, Honduras, and the United States in 2006. The Dominican Republic joined in 2007 and Costa Rica in 2009. From the U.S. perspective, CAFTA

-DR is expected to foster "Made-In-America" jobs, strengthen workers' rights and conditions, and create opportunities for development in Central America.[9]

CAFTA-DR included separate RoOs specific to textiles and apparel, although it contained provisions for exceptions. Survey responses from executives of major U.S. fashion companies show 21 percent source from CAFTA-DR countries without claiming the CAFTA-DR benefits. The fact that these companies do not take advantage of those benefits suggests that the steps needed to utilize the exception provisions are complex and administratively burdensome.[10]

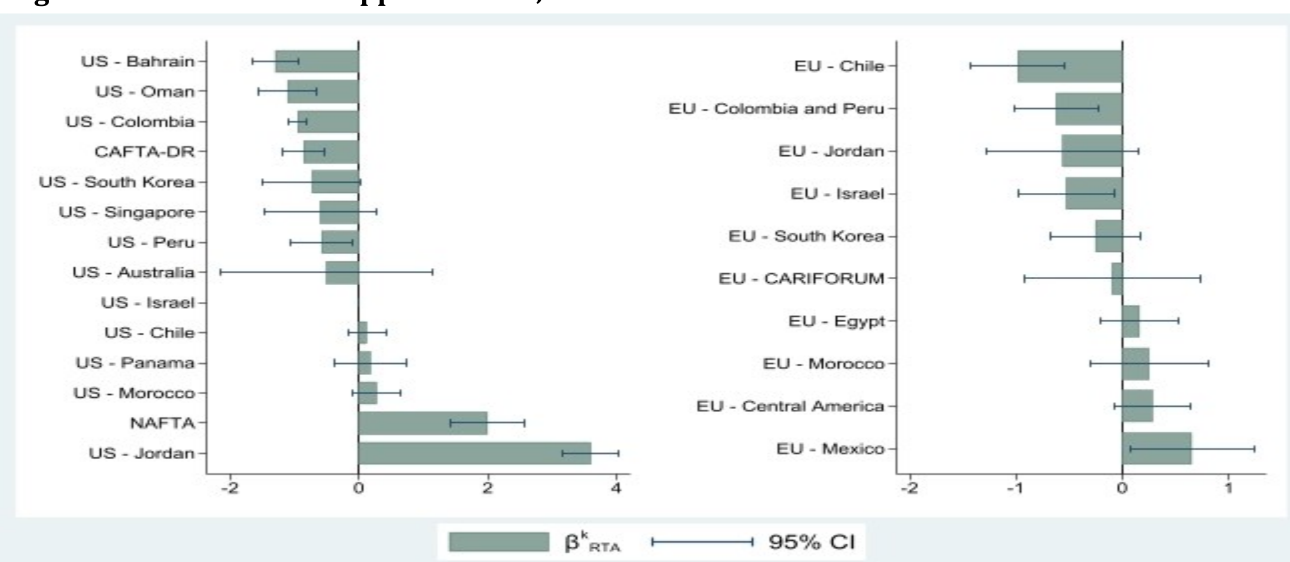
CAFTA-DR is especially restrictive because its RoOs specify a yarn-forward rule or triple transformation, meaning that, not only the clothing has to be assembled in CAFTA-DR countries to qualify, but the fabric and the material the fabric is made from must come from CAFTA-DR countries. As a result, CAFTA-DR apparel exports are about 58 percent lower compared with what trade would have been without the agreement (Figure 1). By contrast, the RTA effect in the U.S.-Jordan agreement, with no yarn-forward rule, is positive and large (3,567 percent). The EU-Jordan FTA has no significant effect. The better performance of Jordanian exports to the United States partly reflects the restrictive RoOs in the EU-Jordan FTA (which involves fabric-forward or double transformation criterion) than in the U.S.-Jordan FTA (which requires single transformation).

Another illustration of the adverse impacts of restrictive RoOs is the tariff preference levels (TPLs) granted to Bahrain, Costa Rica, Morocco, Nicaragua, Oman, and Singapore. TPLs temporarily allow products to enter the U.S. market even though they do not fulfill the requirements for the RTA benefit. Apparel imports from these countries sharply declined following the end of the TPLs as apparel exports of these countries heavily depended on inputs sourced externally.[11]

UPDATING THE RoOs HELPS CREATE JOBS AND ADDRESS MIGRATION

To illustrate the potential employment effects of relaxing the existing restrictive RoOs in CAFTA-

Figure 1: RTA Effects for Apparel Trade, 1988-2019



Source: Abreha & Robertson (2023).

DR, consider a scenario in which CAFTA-DR resembles the "average" agreement. This would increase apparel trade by about 103 percent. Assuming a 10 percent increase in exports increases employment by 2.5 percent (a conservative estimate), the export growth would result in a 26 percent (1.03 x 0.25) increase in employment. Assuming half a million apparel workers in Central America, we might expect an increase of at least 120,000 jobs in addition to the indirect jobs due to the expanding industry.

In 2021, Customs and Border Protection reported 495,276 encounters at the U.S. Southwest border with people from Northern Central America.[12] In terms of direct employment alone, adjusting CAFTA-DR's RoOs could reduce migration by at least 24% if would-be migrants took new Central American apparel jobs instead. Relatedly, a simple analysis of U.S. apparel imports and U.S. remittances suggests that U.S. apparel imports are a substitute for immigration from Latin America.

Overall, the narrow range of inputs and restrictive conditions attached to RTA benefits are likely linked with the limited diversification and product upgrading observed in low-income countries. Hence, it seems worthwhile to consider upgrading the RoOs as a policy instrument to promote economic development in developing countries and address the migration crisis in developed countries.

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Notes:

[1] WTO (2023, January). Regional Trade Agreements Database. http://rtais.wto.org/UI/About.aspx

[2] Abreha, K. & Robertson, R. (2023). Heterogeneous trade agreements and adverse implications of restrictive rules of origin: Evidence from apparel trade. The World Economy. doi: 10.1111/twec.13486

[3] OTEXA. Import and Export Statistics for Textiles, Apparel, Footwear, Leather and Travel Goods. U.S. International Trade Administration. https://www.trade.gov/otexa-trade-data-page

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