

# The challenges and opportunities of free trade agreements: How global trade automation can help

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## Abstract

*Free Trade Agreements (FTAs) and other preferential programmes are a two-headed beast: for almost every business, they can bring substantial benefits through duty reductions and offer strategic competitive advantages. They also create new compliance risks and bring added competitive pressures to the market. The overall prominence and impact FTAs have on global trade have drastically increased in the last 20 years. The utopia of a worldwide market with no barriers, no customs and no constraints, as dreamed by the World Trade Organization (WTO), is no more. The balance of power in geo-politics, and popular rejection of an uncontrolled mundialisation, have replaced that dream with an explosion in bilateral and multilateral trade agreements throughout the world (see Figure 1 for a glimpse of preferential agreements available for the EU). With this proliferation of agreements, how does a company set in motion the changes needed to leverage these FTAs; including the preparation, process changes, risk assessment and supplier/product qualifications? And they must do this while also having to cope with the ever-changing sourcing, manufacturing and selling strategies dictated by a truly global environment, with developed and emerging markets both crucial to business success. It is like jumping on a train while it is moving at 100 kmh. The response is obvious: with dedicated resources, processes and software automation, integrating preferential origin into the whole value chain, gaining strategic competitive advantage — and margin basis points — through every step of the way.*

## Keywords

*Free Trade Agreements, duty reduction, preferential origin, rules of origin, supplier solicitation, BOM qualification, digitalisation, sourcing, manufacturing, agility*

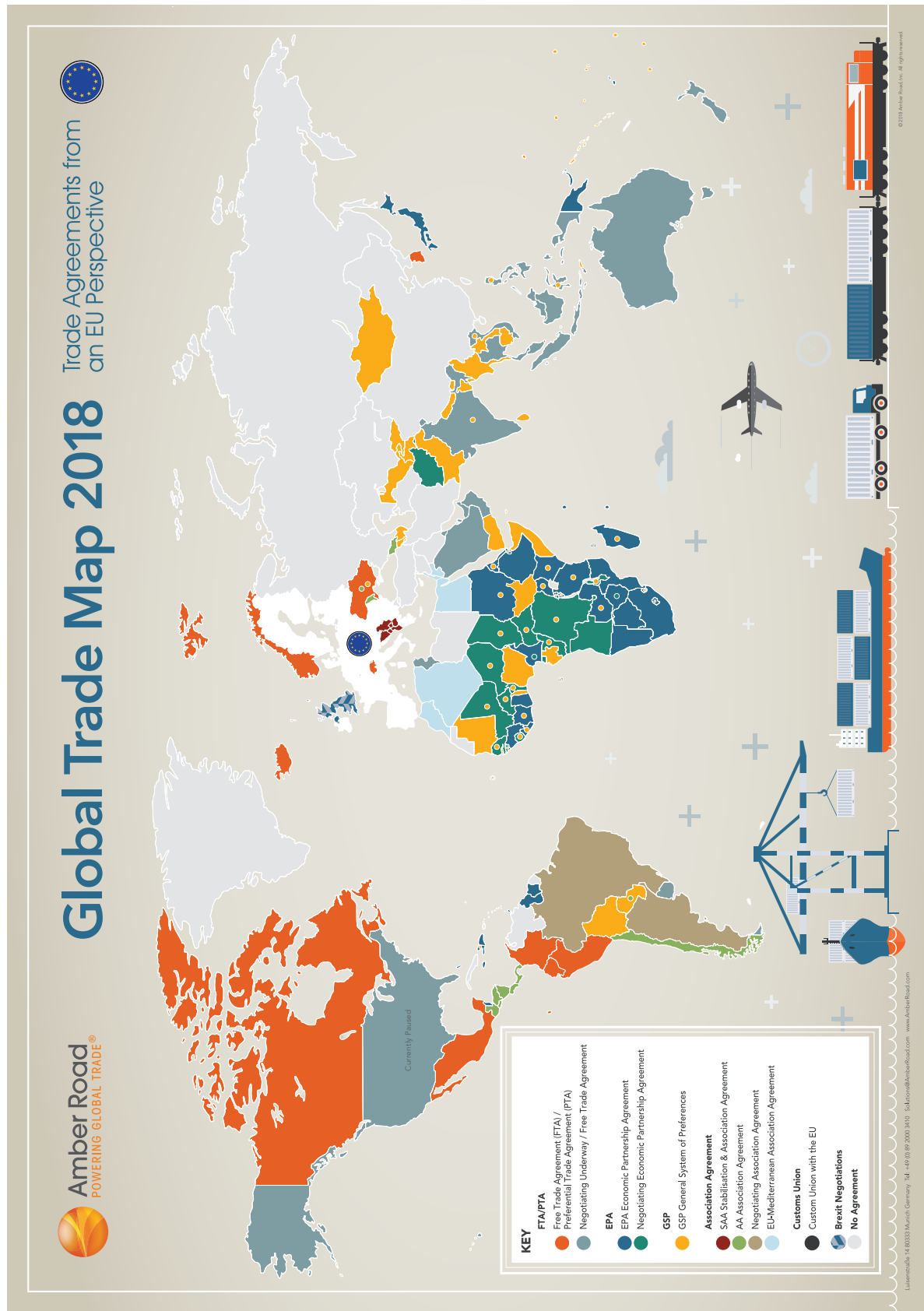
## INTRODUCTION

As with all global trade, the use of Free Trade and Preferential Trade Agreements is a highly technical and regulated facet of global trade compliance. They are

part of a niche domain (international taxes and customs duties), are based on legal texts (FTAs) and quite often negotiated in secret for decades between government bodies. They carry with

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**FIGURE 1** Global Trade Map with EU Perspective, for preferential agreements

Source: Amber Road

them high political exposure and potentially misguided rejection from local populations.

So, like leveraging them in your business, just understanding FTAs requires a multi-layer approach. In this paper, I will use business examples of the fictitious company called ACME, to illustrate and lay down the path to reap the rewards of FTAs, while maintaining full compliance. I will start with the basic question: From a business point of view, why does it matter? Then move to understand the adoption criteria and associated risks of preferential agreement utilisation. Finally, I will discuss the to-do list needed for any business wanting to join the small club of companies already harvesting benefits from FTAs.

## WHY ARE FTAS IMPORTANT TO GLOBAL TRADE?

Before talking about risks, constraints, rules and documents we need to review the rewards. What are the benefits companies can gain from leveraging FTAs? FTAs and preferential programmes are intended to serve multiple purposes: on a geopolitical level, they are meant to favour international trade in goods and services from specific regions, to create mutually beneficial fiscal optimisation to export. Some programmes are intended to facilitate the economic development of poorer countries and contribute to poverty eradication (such as the Generalised Scheme of Preferences (GSP) framework), others are designed to prepare accession to the EU (such as The Stabilisation and Association Agreement with the Western Balkan countries), and others may help to level the playing field through codification of standards and regulations.

But, since it is the baseline and common to all FTAs, and the easiest to understand, as well as the most important to businesses, we will start with the financial rewards — the removal or relief of customs duties.

At the time of import, the importer must declare and pay various taxes. One category of these taxes are import duties. Some products are duty-free, ie the country where you import goods does not apply any duty; this is even sometimes driven directly by the WTO itself (for example, to facilitate trade of pharmaceutical products or electronics). However, most products, for most countries, require the payment of customs duties depending on numerous factors. The amount of the duty can range from a very small percentage, to 25 per cent, 35 per cent and sometimes 100 per cent or more of the value of the goods.

Here are a few examples:

- If you import porcelain bowls from Turkey to the US, the duty rate is 25 per cent of the value of the product;
- An electrical motor for vehicles moving from China to the EU is levied at 2.7 per cent of the value of goods;
- A 5 per cent duty would be charged on accordions from China to Russia.

Name a trade lane and a product, and you will probably end up with a customs duty rate (not taking into consideration the transactions between countries within the EU single market).

By claiming preferential duty and origin at the time of import, ACME Company could benefit from a reduced duty rate; in most cases reduced to zero. This is true for both parts and raw material procured abroad, and for finished goods manufactured by ACME and exported to their subsidiaries,

distributors or customers worldwide. Thus, yielding a bottom line and direct cost saving for both inbound and outbound transactions. Even if ACME is not paying the import duties themselves, they still benefit by lowering the total landed cost of the goods delivered to their customer.

When considering FTAs, you need to first analyse your product lines and trade lanes, asking a three-part question: How much import duties do we pay? Is there an FTA in place for our products and this trade lane? And last, but not least, could we benefit from preferential duties?

Looking at the financial statements (internal or public) of any given company is usually eye-opening. Many companies pay tens or hundreds of millions (Euros, US dollars or their local equivalents) in import customs duties every year. By reducing these tax payments, through legal means, a company can reduce costs, which can immediately flow to the bottom line — improved margins. All this benefit comes with the support and acknowledgment of both the export/import countries. Does this sound too good to be true? There might be a catch. Let us see what is required to achieve ‘preferential origin’ for a product, and hence claim preferential treatment and duties.

## WHAT DO COUNTRIES WANT?

In order to understand the importer’s obligations needed to benefit from an FTA, it is important to understand what the signatory countries want to achieve when they enter in to such an agreement.

Let us keep it simple and focus on the major baseline elements of most bilateral agreements; simply put, two nations agree on the terms of trade between them, with a strong focus on tariffs

and duties which signatories mutually impose on the importation of goods. In other words, this is about increasing the overall trade between the two countries. By decreasing the cost of goods and becoming more competitive.

When the EU signs a new FTA with a country or a region, a new land of opportunity opens. In Mexico for example, ACME (based in the EU) could buy their raw material and parts from Mexican suppliers, with additional transport costs of course, but with no duties. In return, ACME could sell their products in Mexico ‘duty-free’.

FTAs drastically boost the economy by removing trade barriers. Countries and companies can then specialise in goods and services where they excel, and for which they get paid the most (this is the baseline of David Ricardo’s theory of ‘comparative advantage’,<sup>1</sup> in favour of industry specialisation and free trade). In addition to increased economic growth, it is easy to understand that the benefits also include a more dynamic business climate, lower governmental controls, more foreign direct investment, etc.

But, very much like Pandora’s Box, not everything is so bright and easy when it comes to FTAs. Let us elaborate with the North American Free Trade Agreement (NAFTA), which was formulated by the US, Mexico and Canada in the 1990s. After years of negotiations, all three countries agreed on reduced duties for an extensive list of imported products (there were other elements, but we will focus on the duties). As a signatory, each country got something, for something they gave away. For example, Mexico agreed to lower import duties on meat from the US, when the US lowered duties on automotive parts from Mexico.

This preferential channel for goods and services is meant to benefit the signatory

countries, and only those countries. In other words, it would be against the principles of NAFTA to give preferential treatment to beef which originated in China, even though that beef was being imported in to Mexico from the US. The US farmer would not benefit from this type of transaction, thereby circumventing the intent of the agreement.

This is the fundamental cornerstone of FTAs. That is, in order to claim preferential duties and origin, the imported goods must qualify for preferential origin, as described in the legal text, and particularly in what is generally called the 'rules of origin'.

## PREFERENTIAL ORIGIN

We have established the logic of FTAs — two countries agree to reduce import duties on some products, as long as these products are considered originating from the specified countries. But how does an importer define the origin country? It is important to note that this is *not* related to the 'Made in' marking. Preferential origin comes from a set of rules, called the rules of origin, which are part of the FTA's legal text. To be clear, the rules of origin are specific to an FTA (although of course, some countries or the EU tend to standardise them when they can). What qualifies as preferential origin of a cotton T-shirt from Country A could be one rule in the FTA between Country A and B, there may be a different rule in the FTA between Country A and C. To make things even more complex, cotton T-shirts could be simply excluded from an FTA between country A and D!

As illustrated above in the meat and automotive parts example, the negotiation of an FTA between countries can require a long process to reach a mutually acceptable balance. Defining which

products could benefit from preferential duties, under which circumstances and constraints, is typically a long (and usually done in secret to the public) process, which can take years (it took 10 years for the EU–CANADA FTA [CETA] to be negotiated). A key element of those negotiations was the triptych product/duty rate/rule of origin. Simply put, rules of origin are specific to products and are designed to enforce and codify the details of the agreement, which of course is designed to benefit the economies of the signatories. An individual rule may benefit the economy of one signatory (US beef), but another rule may benefit the other country (Mexican automotive parts). To achieve ratification of an FTA, both parties must feel that the entirety of the rules are balanced.

## RULES OF ORIGIN

When writing trade agreements, nations consider the characteristics of a product and the manufacturing processes, with the end goal of deciding whether duty savings programmes for importers would be beneficial to the country's industry and businesses. It is often a long process of negotiation between experts (and industry lobbying groups) in both countries. Each party will want to protect and favour the industries, sectors, businesses, which would be impacted positively or negatively by the future FTA.

Hence, there is a wide diversity of constituents providing input; it all depends on the FTA, and on the type of products. Just having a product on-hand, even with all its details, is not sufficient to determine how it could qualify for preferential origin. Manufacturers must check the legal text of the considered FTA, and find and evaluate the appropriate rule of origin.

For example: ACME is manufacturing a ceramic bowl in Chile, nicely painted and decorated with stickers. They buy unpainted raw bowls from China, pigments from a local producer and stickers from Mexico. They would like to export their finished decorated bowls to the EU. First, they check what the default duties are when importing in the EU and find it is 12 per cent. Second, they check to see if there is an FTA between the EU and Chile. They discover there is one. Maybe ceramic bowls are part of the list of products which could benefit from reduced duties? To determine this, ACME has to refer to the Harmonized System (HS)<sup>2</sup> of tariff nomenclature to determine how to classify their product within this system. The HS was developed by the World Customs Organization in 1988, and is used by more than 200 countries around the world to normalise the classification of products. ACME knows the HS number for their ceramic bowls fall under chapter 69. The legal text of the EU–Chile FTA also uses the HS system (which is common) to define its rules, so it is easy to find the appropriate legal text within the agreement. It turns out there is a single rule of origin which applies to the bowls: ‘Manufacture in which all the [non-preferential] materials used are classified within a heading other than that of the product’.<sup>3</sup> One needs to get used to reading the rules of origin, but basically the text here is saying that the final product must be manufactured from a set of components or raw materials which are significantly different from the final product.

If ACME purchased the unpainted bowl in Chile, and that bowl has a Chilean preferential origin, they can claim preferential duties for the finished decorated bowls (all parts are

originating, hence the finished good is originating) when importing it to the EU. If they manufacture the unpainted bowl themselves in Chile, from clay and other raw material sourced locally, it also qualifies for Chilean preferential origin (the rule of origin is respected). However, in their current sourcing configuration (buying unpainted bowls from China), the rule of origin is not respected. Since they are producing a product using the same type of product (or technically speaking, non-originating materials within the same HS heading), the rule of origin is not satisfied.

Depending on the product, the rule of origin can be very different, and there could even be several ones. Another typical type of rule is called Regional Value Content (RVC), under which the manufactured product must have a certain percentage of its value coming from parts, components and costs originating from the signatory region/countries. In other words, most of the value must come from the signatory countries, which makes sense on a country-level: governments want to develop and favour their local industries, suppliers and workforce.

## WHAT TO DO?

So far, we have seen the process that ACME has to follow in order to claim preferential duties at the time of import, through FTAs. From this simple process comes two complications: 1) the risk of not doing everything in a compliant manner; and 2) the complexity of processing this task for thousands of parts, suppliers, products, over dozens of trade lanes.

Let us first address the risk of non-compliance. What if ACME claims preferential origin at the time of import, pays reduced or no duty, and they are audited by the customs agency? Customs



will require ACME to prove that they were compliant with the preferential rules of origin. The entire process, which has led to the claim of preferential origin, should to be documented so that proof can be made to the authorities when requested. This includes:

- Producing all declarations and documents from ACME's suppliers to prove the preferential origin of the purchased parts and raw materials;
- Producing the Bill of Material (BOM) of the manufactured products, with sourcing prices and costs;
- Demonstrating the BOM/finished good qualification process, including the rule of origin used at the time of preferential qualification;
- Presenting the document(s) or mentions on existing document supporting the preferential claim.

If ACME fails to comply with the complete process, the importing authorities are in their right to assume that preferential origin was not met, and that preferential duties have been fraudulently used. Customs will collect the correct duties, any interest incurred and levy fines and penalties. In addition, this kind of violation, generally gives customs the authority to review all past transactions. ACME is now exposed to many years' worth of audits, which often leads to more duties and back interest, as well as more fines. These historical customs audits can quickly cost a company millions. In summary, a failed compliance test for one product can have repercussions on years of import entries and cost millions.

The second risk is with the complexity of volumes. ACME is purchasing and shipping goods all over the world. Combine this with the fact that each

FTA has its own set of unique rules, and it is easy to see that ACME has exponentially increased its compliance exposure. Any single customs entry, filed with an invalid FTA claim, could potentially trigger a customs audit. Many governments throughout the world are currently in a period of austerity, and are not keen to relinquish duties without the proper proof and documentation.

On both the individual process and with significant business volumes, this is where software automation could simplify ACME's processes, and ensure total compliance from end-to-end, while maximising preferential benefits. We have discussed how the risks and benefits from an FTA could vary depending on one business's activities. We will now take a look at the complete spectrum of the connected and automated process of supporting an FTA. If our reader has a less diversified activity (for example, a pure reseller, buying and selling parts but not manufacturing any), it should be quite simple to extrapolate to a business principles from the complete picture.

## **AUTOMATION, COME TO OUR AID**

### **Supplier solicitation**

This first step of automation and harvesting its benefits is all about the goods that are inbound within a supply chain. It focuses on components and raw materials that ACME is purchasing, with intent to manufacture their own products, or on products that they are buying to resell directly.

In either case, the proof of preferential origin must come from the suppliers, the original manufacturers who knows their BOM components, their own suppliers and sourcing lanes, their costs and prices, their manufacturing and multi-tier

supply chains. Potentially also passing on the process to their suppliers (tier 2, tier 3 suppliers).

Most of the FTAs have a provision to make this step easier in the long run: there is the possibility for the supplier to create and send a declaration, or a certificate, which will certify the preferential origin of the supplied goods, spanning a certain period of time: in Europe a Long Term Supplier Declaration (LTSD); elsewhere, a Certificate of Origin (CoO). These documents could be valid for one to two years, depending on the FTA.

So, in this process, ACME would solicit their suppliers, usually every year, to collect two things – the preferential status of the sourced products and the document supporting such a claim.

This is the first area where software automation can make the complete process much leaner and connected. The solution starts by capturing and storing the sourcing information. This is the link between purchased component or raw material and all the potential suppliers of that good. From this set of data, a software solution will create what are called ‘Solicitation Campaigns’. This activity groups suppliers and parts under a given preferential programme or FTA framework and automatically consolidates them in to a manageable set of records. As previously discussed, the legal requirements, such as certificate formats and specific data elements are FTA specific. A highly functional software platform must support these unique requirements.

Again, software automation can make the response easier to create for ACME’s suppliers, with a dedicated portal with data segregation, in order to fulfil and complete their requirements toward ACME.

Finally, once the supplier has completed its answers, the software

solution can generate the LTSD or CoO, if applicable, with the exact format and data that the FTA requires. From there, the supplier only has to sign it (physically or electronically) and send back a complete package to ACME.

Of course, all this process needs to be conducted at an FTA level; suppliers can regroup several responses into one campaign, but their responses have to be FTA-specific (there are some exceptions to this rule), since each agreement could have different rules of origin for the given product. Therefore, the automation software platform needs to be updated with the latest legal requirements, documents and response formats, ideally, this is accomplished in an automated fashion as the FTA rules and requirements change.

From ACME’s point of view, receiving a supplier response to a solicitation campaign allows the responsible person(s) to review the responses. Of equal importance, the platform also links the response to the product master data, on a sourcing level, and therefore allows ACME to track down the responses and the documents in case of an audit from customs agencies. Of course, this is also fundamental if ACME is reselling the parts.

Just as important, we will see that those suppliers’ responses will be the foundation of the second step of ACME’s journey: BOM qualification.

## **BOM qualification**

Now, we are getting to the second step of ACME’s operation: they are manufacturing products, and they would like to qualify them for preferential origin, for a set of given FTAs. This could be beneficial in numerous situations: they are shipping goods to their subsidiaries, they are importing the finished goods themselves abroad or they would like to



remove the cost of import duties to their customers/partners/distributors.

We have discussed the complete process earlier: ACME is considering a given product and a given trade lane; if an FTA exists in the trade lane, the ACME compliance team should refer to the FTA legal text and find the applicable rule of origin for the harmonised tariff classification of the manufactured product. As an example, consider an electrical motor, in which the rule of origin specifies that the RVC must be at least 60 per cent of the value of the finished good.

This is where software automation can really help ACME perform the process of qualifying the electrical motor for preferential origin. The starting point is the complete BOM, in other words the list of parts (including their sourcing and prices), and costs associated to purchased parts and labour and other indirect costs. For the electrical motor, assume that the finished product has a total cost of €100, split as €20 of labour, €20 for one stator, €20 for one frame, €20 for two commutators, €15 worth of various bearings and €5 worth of smaller parts (this split of cost is the actual BOM).

From there, software automation will identify if an FTA exists for a given trade lane, and also if the specific product might be eligible for preferential duty relief. The software can link everything together, starting with the finished product and its BOM, and identifying its components and their sourcing. Because ACME has made a proper solicitation campaign with its suppliers the previous year, the software contains up to date preferential origin (and associated supporting documents) information for every component. Since all information is in a digital form, including the rules of origin, the software can automatically

determine the FTA eligibility for the finished produce.

For the electrical motor, imagine that the stator, the frame and the bearings have preferential origin; the commutators do not, and the smaller parts have unknown preferential origin (and therefore are considered non-preferential). The sum of originating value is therefore in this context: €20 of labour, €20 of stator, €20 of frame and €15 of bearing, making it a total of €75 worth of originating value over a total cost of €100; or 75 per cent of the cost, which is above the 60 per cent of regional value content required by the rule of origin. The electrical motor qualifies in this context, and ACME can claim preferential duties.

But this is just the start of the work: ACME has qualified its manufactured electrical motor, based on a given sourcing and context. But imagine that a procurement specialist has the opportunity for a great deal on the stator from a new supplier; coincidentally, this stator does not qualify for preferential origin for this FTA. All of a sudden, the preferential status of the finish product, the electrical motor, is no longer valid since the RVC is only of 55 per cent. What seemed like a smart procurement decision to save 2 per cent on the cost of one part, actually increased the cost 12 per cent since the electrical motor no longer qualifies for preferential duties. The same kind of situation may apply to a change in design, which may change the cost of a main part: a potential smart and intelligent change, but which could have a negative consequence on duties.

In those two simple, yet catastrophic examples, something has changed within the company. Now picture a scenario where the stator is bought in foreign currency, at a time when the currency is

very dynamic. These currency fluctuations, could impact the preferential origin of ACME's products, as well as open the door for a major and costly customs audit.

This is where software automation can really change the game. It can enable the move from a one-time BOM qualification programme (which could already be problematic with big volumes) to an automatic surveillance paradigm. Think of this as a 'digital sentry', where the finished good BOM is requalified against the relevant FTAs when any significant data has changed. This results in a continuous up to date database as well as allowing for simulation of things such as currency fluctuations, design or sourcing changes. And of course, software can streamline and automate the management and updating of the rules of origin, from a connected regulation database.

### Certificate management

We have come to the last, but not least, part of the preferential origin virtuous circle — certificate management. When ACME is claiming preferential origin and reduced duties at the time of import, customs authorities require a supporting document; sometimes a simple mention on a commercial invoice is enough (depending on the FTA), other times a certificate of origin for the product is required and other situations might require a certificate of origin referring to the transaction line.

Through supplier solicitation to BOM qualification, it is crucial to be able to efficiently and automatically generate such certificates. Foremost, shippers need to distribute them to the appropriate recipients, store and reference them for future audits and be alerted when they expire or become invalid.

In that area, automation software can save effort and concern for ACME. Since all product-related information is stored and maintained within a single platform, along with the results of supplier solicitations and of BOM qualifications, it makes sense to centralise the determination, generation and distribution of the resulting certificates of origin. Additionally, it can be a challenge to keep up with and maintain the certificate template changes across many FTAs. Software that has been designed to stay up to date in an automated fashion, is perfect for this type of problem.

### CONCLUSION

Qualifying goods for preferential origin and duty is not an easy task. It becomes more difficult with higher business volumes, and is close to impossible when considering the constantly changing environment created by the dynamics of Industry 4.0<sup>4</sup> and the new market distribution demands.

Luckily, automation software can solve a big chunk of the challenge. Connected to a regulatory content database (when updated and monitored by a team of global trade professionals), software can identify the potential benefits automatically, detect new opportunities, on-board and monitor the solicitation of suppliers, automate the BOM qualification and alert the appropriate resources when any change puts the company at risk for compliance violations.

Of course, as with any tool, correct internal processes need to be in place to support the transformed digital operation. This is especially true given the fact that every actor in the value chain is potentially a stakeholder or contributor: design, procurement, supply chain, manufacturing, supplier management, customer management, compliance, etc.

could all have positive and/or negative impacts on the preferential origin within the manufacturing and supply chains.

A global trade management (GTM) software solution, combined with integrated and intelligent regulatory content, is a great way to reap the benefits provided by FTAs. Through digitalisation, collaboration and analytics, cross-border trade becomes less risky, more agile, and most importantly, opens access to an untapped source for improved margins. A GTM solution of this breed becomes a cornerstone to implement new free trade agreements in your company's global operation as a source of savings and a gateway to new markets. The advantage will be yours,

while the unequipped competition will continue to operate under 'business as usual'.

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