THE GAESEONG INDUSTRIAL COMPLEX AND THE KOREA-U.S. FTA: Part 2*

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Useful FTA Precedents

A. Rules of Origin

As to the KORUS FTA, it would be meaningful to explore the various precedent FTAs where the exceptions to the rules of origin have been adopted. Such exceptions to the rules of origin can be found in the FTAs that the U.S. and Singapore concluded with certain other countries or regional economic associations, respectively. By and large such exceptions to the rules of origin can be classified into two types: (1) outward processing; and (2) qualifying industrial zone. As discussed below, it seems that FTAs between U.S. and Israel and U.S. and Singapore can be a useful precedent of current issue whether the GIC-made products can qualify for preferential tariff treatment under the KORUS FTA.

The rules of origin identify the "nationality" of a product. Its objective is to limit FTA tariff preferences to goods which originate from member countries. For example, in the context of the KORUS FTA, only ROK or U.S. products enjoy the tariff preference under the FTA. Generally, in respect of the origin criteria, the products are divided into two categories: (a) wholly obtained criteria that are completely obtained and produced in a particular country

* This paper was prepared for presentation at the 2nd international symposium on "North Korean Development and International Cooperation," co-organized by the Export-Import Bank of Korea and the University of North Korean Studies, Seoul, Korea, July 6-7, 2006. (Part 2 of 2)

(e.g., livestock born and bred in such a country); and (b) substantial transformation criteria.

In case of the substantial transformation criteria, the following three rules are regarded as general rules of origin. However, actual rules of origin depend on each country since most countries have their own judgment standard.

i) Change in tariff classification: Essentially the rules of origin require that the products be substantially transformed in a particular country. Such transformation is deemed to have occurred in such a particular country if there is a change in tariff classification;

ii) Value-added content rule: Under this rule, the products will qualify for preferential tariff treatment if percentage of local content exceeds a certain percentage usually ranging between 40% and 60%; and

iii) Principal process requirement: Under this requirement, a principal process required to manufacture the product must be done in a country if it can acquire originating status.[1]

The concept of outward processing is derived from the value-added content rule. The outward processing in the context of a FTA is understood to mean that a good can be taken out of the territory of a party to a third party for some processing, and then brought back to the territory of the party for the manufacture of the final product for export to the other party. The concept accumulates the value addition which takes place in the territory of the exporting party at different stages, disregarding the value addition which takes place in the territory of the third country.[2] The inclusion of outward processing in FTA negotiations is not common,

[1] Myung-Chul Cho, et al., Strategies for Promoting Exports of Companies in Gaeseong Industrial Complex, Korea Institute for International Economic Policy, December, 2005. pp40-41

[2] For instance, assume that electric irons are assembled in Batam, Indonesia, using parts and components made in Singapore. The iron is then tested in Singapore before exported to the U.S. Usually, the rules of origin only count for the final stage of the process and any content made in the initial stage of process is disregarded. Thus, in the above case, the value of the Singapore parts and components made in the initial stage is disregarded and only the value of testing in the final stage is recognized as the Singapore content. But by recognizing the outward processing activities, the value of the Singapore parts and components made in the initial stage can be

however, in some instances they have been adopted in FTAs. It should be noted that the outward processing concept was actively sought by EFTA and Singapore in concluding FTAs with their respective counterpart. EFTA is known to have concluded 14 of its trade partners, 11 of which contained the outward processing provision. Especially in case of Singapore, as Singapore is a small country, most production process is conducted outside Singapore, and thus Singapore needs outward processing clause in the FTA.

In connection with the current KORUS FTA negotiation, it is worth looking into the FTA precedents that includes the concept of outward processing or its equivalent.

B. U.S.-Singapore Free Trade Agreement ("USS FTA")[3]

In case of the USS FTA, U.S. and Singapore recognized the outward processing arrangement.

The rules of origin are contained in the so-called Integrated Sourcing Initiative ("ISI") in the Article 3.2 and Annex 3B of the USS FTA, which is based on the main principle that certain goods, although not manufactured in Singapore, will be deemed as originating from Singapore if they are imported from Singapore, and hence enjoy preferential benefits accorded to a Singapore good. While the ISI list includes 266 products including, among others, information technology products and medical devices in the U.S. and Singapore, the list is not closed, with a provision to allow the product coverage for the ISI to be expanded.

In relation to the concept of ISI, Article 3.2 of the USS FTA provides as follows:

> ARTICLE 3.2: TREATMENT OF CERTAIN PRODUCTS
>
> 1. Each Party shall provide that a good listed in Annex 3B is an originating good

recognized as Singapore content as well and thereby raising the Singapore content.

[3] USS FTA was executed in 2003 and became effective in 2004.
USS FTA is available at http://www.ustr.gov/Trade_Agreements/Bilateral/Singapore_FTA/Final_Texts.

when imported into its territory from the territory of the other Party.

2. Within six months after entry into force of this Agreement, the Parties shall meet to explore the expansion of the product coverage of Annex 3B. The Parties shall consult regularly to review the operation of this Article and consider the addition of goods to Annex 3B.

There is a view that this ISI provision may be of limited precedent for including the GIC in the KORUS FTA because most of the products covered by the ISI provision already traded duty free under the World Trade Organization's Information Technology Agreement. However, U.S. accepted the concept of the ISI which is an exception to the rules of origin in the USS FTA and as such it is meaningful for the GIC.[4]

Further, with regard to the concept of outward processing, the USS FTA explicitly provides as below:

ARTICLE 5.11 DEFINITIONS

4. Outward Processing Arrangement means the arrangement whereby a registered Singapore textile or apparel goods producer is permitted to process outside Singapore subsidiary or minor processes of its textile or apparel goods without affecting the Singapore country of origin status of the textile or apparel goods.

C. Korea-Singapore Free Trade Agreement ("KS FTA")

The outward processing concept was adopted and incorporated in the KS FTA. Specifically, the KS FTA explicitly provides for the term, outward processing in Article 4.4 to recognize the exceptions to the rules of origin. This outward processing provision applies to HS 10

[4] According to CRS Report, "although the ISI would have no effect on duties paid, it was designed to help American companies eliminate extra paperwork, fees and red tape. Additionally, USTR officials have said that the ISI was very unpopular with Congress."

Code 134 items. Article 4.4 of the KS FTA states as follows:

> ARTICLE 4.4: OUTWARD PROCESSING
>
> 1. Notwithstanding the relevant provisions of Article 4.2 and the product-specific requirements set out in Annex 4A, a good listed in Annex 4C shall be considered as originating even if it has undergone processes of production or operation outside the territory of a Party on a material exported from the Party and subsequently re-imported to the Party, provided that:
>
> (a) the total value of non-originating inputs as set out in paragraph 2 does not exceed forty (40) per cent of the customs value of the final good for which originating status is claimed;
>
> (b) the value of originating materials is not less than forty-five (45) per cent of the customs value of the final good for which originating status is claimed;

In particular, in respect to the issue of GIC-made products, the KS FTA is notably recognized as the first FTA for identifying the goods manufactured in GIC as the Korean-made goods, although it has, to some degree, deviated from the original concept of outward processing. Rather, the inclusion of the GIC products in the category of Korean-made products under the KS FTA is in nature similar or equivalent to ISI as adopted in USS FTA or the concept of qualifying industrial zone adopted under the U.S.-Israel FTA as discussed below. This specific provision for the GIC products applies to HS 6 Code 4,625 items. In any event, the KS FTA is the first FTA which allows the goods manufactured in GIC to have free-duty access to a foreign market. Relevant provisions are as follows:

> ARTICLE 4.3: Treatment of Certain Goods
>
> 1. The goods listed in Annex 4B shall be originating goods when the goods are imported into the territory of Singapore from the territory of Korea. The goods

shall also be originating material for purposes of satisfying the requirements specified in this Chapter.

2. Upon request of a Party, the Parties shall have consultations on the operation or revision of this Article and Annex 4B.

Annex 4B: Originating Goods Referred to in Article 4.3

Section 2

1. With a three (3) months' notice in writing, Korea may add goods to the table in Section 1, unless Singapore in good faith indicates otherwise to Korea.
2. It is understood that goods listed in Section 1 are produced in the Gaeseong Industrial Complex and other industrial zones on the Korean Peninsula.[5]

D. Korea-EFTA Free Trade Agreement ("KE FTA")

On December 15, 2005, Korean government and the four trade ministers from the EFTA member nations signed the free trade agreement. EFTA comprises four European nations - Iceland, Norway, Switzerland and Liechtenstein - that are not members of the European Union. A salient feature of the agreement is that it adopts typical outward processing method and thus there is no specific provision for the GIC-made products. This outward processing provision applies to HS 6 Code 267 items. APPENDIX 4 TO ANNEX1 of the KE FTA states as follows:

EXEMPTIONS FROM THE PRINCIPLE OF TERRITORIALITY[6]

2. Notwithstanding Paragraph 1. for products listed in the Table set out at the end to this Appendix, the acquisition of originating status shall not be affected by working or processing carried out in an area, for instance an industrial zone, outside the

[5] For Korea-Singapore Free Trade Agreement, see http://app.fta.gov.sg/asp/fta/pagetemplate1.asp?pg_id=korea_legal_text&ctryname=Korea&pagetitle=Legal%20Text.

[6] For APPENDIX 4 TO ANNEX1 of the KE FTA, see http://secretariat.efta.int/Web/ExternalRelations/PartnerCountries/KR/KR_RUAP/annexes/KR_Annex_I_Appendix_4.pdf.

territory of a Party, on materials exported from the Party concerned and subsequently re-imported to that Party, provided that

(a) the total value of non-originating input as set out in paragraph 5(b) does not exceed 40 per cent of the ex-works price of the final product for which originating status is claimed; and

(b) the value of originating materials exported from the Party concerned is not less than 60 per cent of the total value of materials used in manufacturing the re-imported material or product.

E. KOREA-ASEAN FTA

As noted above, the Korea-ASEAN FTA has not been finally concluded yet. However, both countries reached an agreement on Trade in Goods in the Korea-ASEAN FTA in April, 2006, and subsequently, provisions as to the GIC was agreed in May, 2006. The Korea-ASEAN FTA reportedly includes outward processing provision similar to KE FTA. However, such outward processing provision applies to only HS Code 100 items. Because ASEAN worries that the GIC-made products would have negative impact on its economy, ASEAN reluctantly agreed to the inclusion of the GIC in the FTA with certain restrictive conditions which are (1) limiting number of products to 100, (2) reserving the right to withdraw preferential treatment after 5 years, and (3) safeguard provision to the GIC-made products.[7]

F. Qualifying Industrial Zone

The concept of Qualifying Industrial Zone ("QIZ") is one of the concepts which was adopted and implemented under the U.S. – Israel FTA and other FTAs that the U.S. concluded with some of its Middle East counterparts. Under this concept U.S. allowed goods manufactured

[7] Ministry of Foreign Affairs and Trade, the Outcome of the 12th Round of Negotiations between Korea and ASEAN, May 30, 2006.

in areas other than Israel to be exported duty free to the U.S. market.

(1) Concept of QIZ

QIZ was originally initiated in 1996 by the U.S. Congress as part of its efforts to support the peace process in the Middle East.[8] Subsequently, the U.S. Congress amended the U.S.-Israel Free Trade Area Implementation Act of 1985 (the "Act") by adding at the end of Section 9 of Additional Proclamation Authority. Section 9(a) of the Act grants the U.S. President the additional authority to proclaim elimination or modification of any existing duty as the President determines is necessary to exempt any article from duty as to products of the QIZ.

Pursuant to the Section 9 (e) of the Act indicated above, the QIZ was defined as any area that: (a) encompasses portion of the territory of Israel and Jordan or Israel and Egypt; (b) has been designated by local authorities as an enclave where merchandise may enter the U.S. market without payment of duty or excise taxes; and (c) has been specified by the President as a QIZ. Presidential Proclamation 6955 delegated to the United States Trade Representative ("USTR") the authority to designate QIZs.[9]

(2) Areas Designated as QIZ

Since 1999, the USTR has designated 10 industrial parks in Jordan as QIZs.[10] In 2004, the USTR designated 3 new QIZ areas in Egypt including Greater Cairo QIZ, Alexandria QIZ and Suez Canal QIZ.

[8] For QIZ Frequently Asked Questions (posted on the website of U.S. Embassy in Amman), see http://www.usembassy-amman.org.jo/QIIZ.htm.
[9] Federal Register: November 16, 2005 (Volume 70, Number 220), Notices, pp. 69622 – 69623.
[10] They are the Gateway QIZ on the northern Jordan-Israel border; Al-Hassan Industrial Estate in Irbid; Al-Tajamouat Industrial Estate in Amman; Ad-Dulayl Industrial Park near Zarka, the Kerak Industrial Estate, Aqaba Industrial Estate, Jordan Cyber City, Al-Qastal Industrial Zone in Amman, Mushatta International Complex in Amman, and El-Zai Readywear Manufacturing Co. in Zarqa. See QIZ Frequently Asked Questions, op. cit.

(3) Primary Requirements for Obtaining Duty-Free Treatment

In order for a QIZ article to gain duty-free entry, the product must meet the following requirements:

(1) It should be wholly the growth, product or manufacture of the QIZ or a new or different article of commerce that has been grown, produced or manufactured in the QIZ;
(2) The sum of (i) the cost or value of the materials produced in QIZ, the West Bank, the Gaza Strip, or Israel plus (ii) the direct costs of processing operations performed in QIZ, the West Bank, the Gaza Strip, or Israel, is not less than 35 percent of the appraised value of such articles; and
(3) It should be imported directly from the QIZ or Israel.[11]

(4) Operation of QIZ and Responsible Governing Organization

A joint committee is formed with two co-chairmen: a Jordanian/Egyptian appointed by the Jordanian/Egyptian Government, and an Israeli appointed by the Israeli Government, plus an observer from the United States, whose task is to approve all products eligible for duty-free entry into the U.S. market. The meetings of the committee take place, alternately, in Jordan/Egypt and Israel. Coordination is made via co-chairmen of the committee. Co-chairmen are responsible for filing and keeping all submitted materials for a period of at least five years. The committee is allowed to alter or add to its rules of procedures.[12]

(5) Salient Features of QIZ and Its Implication to the GIC

[11] Section 9 (a) of the United States-Israel Free Trade Area Implementation Act of 1985, as amended (19 U.S.C 2112 note).
[12] Article II-Economic Cooperation of the Agreement between the Hashemite Kingdom of Jordan and Israel on Irbid Qualifying Industrial Zone.

As shortly mentioned above, the QIZ program was designed, based on the idea that business was apolitical and thus would be ideal to cement deeper connections, in an effort to secure the peace among Israel, Palestinian, Jordan and Egypt in the Middle East Region. This genesis of QIZ program can be affirmed from the fact that QIZ areas have been built in parts of both Israel and its neighboring nation, though the areas did not have to be contiguous, and from the QIZ product requirements that the 35 percent of the appraised value of a good must come from a combination of Jordan (11.7%) and Israel (7-8%) with the remainder from Jordan, the U.S., the West Bank, Gaza Strip or Israel.[13]

Given the background of the creation of the QIZ concept, the QIZ may be well comparable to the GIC in that the GIC was developed and operated as a part of inter-Korean efforts to secure peace on the Korean Peninsula. Moreover, as we note that *Gaeseong* area of the North Korea was one of the key military strategic fortresses facing straight ahead of South Korean territory prior to the development as an industrial complex as it is, it becomes more and more important and significant for the GIC to be properly recognized as a SEZ equivalent to QIZ, under the KORUS FTA to enhance the peace process between the two Koreas.

G. Brief Summary

The analysis of several FTA precedents which include some exceptions to the rules of origin shows that there are various ways to deal with the exceptions to the rules of origin in the context of the current KORUS FTA negotiation. Final resolution depends on various factors including expected impact on counterpart country's economy, need of counterpart country to include exceptions to the rules of origin, and political interest of counterpart country in ROK and North Korea. In case of Singapore and EFTA, they needed to have outward processing provision by themselves and the impact on their economy was not deemed to be substantial. Especially they did not have a special political interest in dealing with the GIC issue.

[13] *Ibid*.

Therefore, the GIC related provision could be included in the respective FTAs with ROK without much difficulty. In case of ASEAN, ASEAN worried that the GIC-made products would have a negative impact on its economy and thus several conditions favorable to ASEAN were included in the Korea-ASEAN FTA.

Meanwhile, it is noteworthy that the U.S. accepted the exceptions to the rules of origin in USS FTA and US-Israel FTA, and especially that the purpose of QIZ was to serve to secure the peace in the Middle East Region.

Based upon these FTA precedents, we need to examine the possible resolutions of the GIC issue. One compromise recommended by the IIE Report is as following; "Getting two sides on a common page regarding policies toward North Korea will be contentious and require skillful management. … Given North Korean intransigence, we suspect that the prudent course would be to exclude North Korean-produced goods and services from the FTA until compliance with the pact's rights and obligations can be adequately monitored and enforced. But it also makes sense to support the South Korean vision for Korean unification by setting out procedures in the FTA itself for updating the pact if and when the reunification process advances." However, this recommendation does not appear to be useful since it is in fact excluding the GIC in the KORUS FTA. Neither is there a promise to include the GIC in the KORUS FTA.

The other compromise would be to limit the number of items and the length of the preferential treatment period for the GIC-made products as in the case of Korea-ASEAN FTA. Items may be reduced to a considerably low number and such items may be selected in line with export control regulation. The period for the preferential treatment may be set for a relatively short period of time (3 or 5 years), and each government would have the opportunity to closely examine the outcome of the GIC and then decide whether to expand or get rid of such preferential treatment of the GIC-products. Taking into consideration the

strategic value of the GIC, I would like to strongly support this compromise.

Conclusion

I would like to conclude by summarizing several points. First, the U.S. government does not appear to have sufficient understanding of the GIC, and there have not been close communications and discussions between the both governments as to the strategic value of the GIC. In this regard, the ROK government needs to closely examine current situation and try to make favorable environment to persuade the U.S. government. For this purpose, the ROK government needs to prepare a white book or information memorandum that provides detailed information regarding the GIC, including the current status, development plan, legal infrastructure, prospects, its strategic value, and the comparison with early Chinese SEZs and other SEZs of North Korea.

Second, as discussed above, certain unprecedented advanced measures have been taken by North Korean government in the GIC, and certain important progresses are being made, which implies that a meaningful experiment has started in the North Korean society and it may have the same spillover effect as Shenzhen SEZ did in a similar way in China about 20 years ago. Further, the GIC itself is not related to any political activities or illegal activities, but it is only a place where pure economic activities are performed. The strategic value of the GIC needs to be fairly estimated, and close communications and discussions between the both governments need to be arranged by the ROK government's initiative so that both governments share common understanding of the GIC.

Third, it is difficult to predict whether the KORUS FTA will include the GIC. As discussed above, both governments insist on their own original positions, and the difference does not appear to be easily narrowed. From a purely economic perspective, the GIC issue may be a

minor issue compared to the other prevalent negotiation items.[14] However, the GIC is something unique that may not be simply measured from pure economic perspective, because its strategic value should not be disregarded or underestimated. It is the only remaining hope to bring changes in North Korea, and there are sufficient grounds to believe in such a possibility. Considering the strategic value of the GIC, the GIC needs to be included in the KORUS FTA, even if such an inclusion means a limited number of products included for a relatively short period of time.

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[14] "Realistically, the volume of exports emanating from [G]aeseong will likely remain trivial for some time. Nonetheless, the South Korean side may well insist on its inclusion. From the standpoint of rapidly and successfully concluding an FTA between the United States and South Korea, however, a request for duty-free treatment for [G]aeseong-produced goods is a high-cost, low-payoff addition to the negotiating agenda-and one that could put the entire initiative in jeopardy." IIE Report, p.12.