

products, a certain percentage of the value added in processing and manufacture must occur in the member countries in order to qualify for duty-free access among all of them.

Rules-of-origin criteria avoid the need for members of an FTA to adopt common import restrictions. However, whenever discrepancies in import barriers among the member countries are large, there is an incentive to locate production in the member country with the lowest import barriers in order to capture the benefits of the pass-through effect. In the case of Canada and the United States, this problem could arise in sectors characterized by managed trade, where quotas and tariffs already are being applied to particular products. In sectors such as textiles or clothing, the potential discrepancies between import barriers can be very large, and considerable administrative difficulties exist in ensuring compliance with rules-of-origin criteria. For example, offshore imports of such products might flow through a member country with relatively lower import barriers and then be given the minimum value added needed to gain tariff-free entry to the member with higher import barriers. In this case, the member with higher barriers might urge the other to raise its external barriers. Furthermore, if the country with the lower barriers has a domestic import-competing lobby to reinforce these pressures, that country might be persuaded to emulate the higher import barriers.

One way to respond to such pressures is to apply different rules-of-origin criteria to different types of products. For goods that already trade freely, or that are subject to low trade barriers, the value-added requirement could be relatively low — say, 30 percent. In sectors that are highly protected by tariff and nontariff barriers, a higher value-added requirement could reduce the likelihood of production deflections and lessen pressures for harmonization of external trade barriers.