Rules of Origin and Uncertain Cost of Compliance[*]

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Abstract

To consider the role of uncertain production cost resulted from complying with rules of origin (ROO), we formulate a Cournot oligopoly model of free trade area (FTA). If exporters do not comply with ROO, they must pay the external tariff. On the other hand, if exporters comply with ROO, they enjoy zero tariff but suffer uncertain production cost. Because compliers must use a certain ratio of the input produced within the area, they face fluctuations of input-price in that area; it yields uncertain production cost for compliers. This uncertain cost gives a benefit from its variance to compliers. Therefore, in an intermediate level of external tariff, strategic substitution emerges among exporters' choice. We show that the coexisting of compliers and non-compliers appears among symmetric exporters. We also discuss on the endogenous rate of ROO-compliers in the coexisting equilibrium of compliers and non-compliers. We show that if the variance of uncertain production cost is small, the rate of ROO-compliers in the coexisting equilibrium increases with the number of total exporters inside FTA.

Key words: Rules of origin (ROO); Compliance; Uncertain production cost; Oligopoly

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