

Why is the Utilization of U.S. Free Trade Agreements Falling for Apparel Imports?

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Background: Free trade agreement (FTA) is a treaty in which two or more countries agree to lower trade barriers and promote mutual market access (Crawford & Laird, 2001). With the number of FTAs implemented in the United States almost doubled in the past ten years, theoretically, U.S. firms should import more apparel under FTAs (USTR, 2017). However, the utilization rate of U.S. FTAs for apparel imports, i.e. the value of apparel imports under FTAs as a percentage of apparel imports from the FTA regions, has significantly dropped from 94% in 2005 to only 81.0% in 2016 on average (OTEXA, 2017). The purpose of the study is to explore why is the utilization of U.S. FTAs falling for apparel imports. Whereas most existing literature on FTAs focuses on evaluating the trade creation and trade diversion effects, the utilization of FTAs, especially in the apparel sector, has little been studied (Pickles, Staritz & Glasmeier, 2015). Findings of the study will fulfill a critical research gap and contribute significantly to our understanding of the impacts of FTAs on U.S. apparel firms' sourcing decisions. Results of this study will also offer valuable inputs to policymakers in support of their design of future FTAs.

Literature review: U.S. FTAs typically require that apparel qualified for preferential tariff treatment need to be made in the FTA region starting from the spinning of the yarns, which is known as the yarn-forward rules of origin (RoO) (Pickles et al., 2015). Because most developing countries do not have the capacity of manufacturing textiles, the United States often is the sole textile supplier in the whole FTA regions, especially in the Western-Hemisphere (Curran, 2016). For certain textiles that not even the United States produce, FTAs may include mechanisms such as the trade preference level (TPL)¹ and the short supply list (SSL)², to loosen the yarn-forward RoO restrictions. Based on a revised mathematical model of Krueger (1993), it shows that three factors will affect the utilization of U.S. FTAs for apparel imports: first, the U.S. import tariff rate for apparel is positively related to the utilization rate (*H1*). Second, the restrictiveness of the RoO is negatively related to the utilization rate (*H2*). Third, the import tariff rate for textiles in the apparel exporting country is positively related to the utilization rate (*H3*).

Methods and data:

The following empirical model was estimated to test the proposed hypotheses:

$$FTA_{it} = \beta_{1it} TTFTA_{it} + \beta_{2it} TAUS_t + \beta_{3it} TPL_i + \beta_{4it} SSL_i + \beta_{5it} WH_i + c_i + \varepsilon_{it} \quad (1)$$

Where: FTA_{it} refers to the utilization rate of FTA i for apparel imports in year t ; $TTFTA_{it}$ denotes the average applied tariff rate for textiles (HS Chapter 50-60) in FTA i (apparel

¹ TPL provides preferential market access for specified quantities of textile that do not meet the RoO criteria, but that are subject to significant processing in the FTA regions (USTR, 2017).

² SSL allows textiles not available in commercial quantities in a timely manner from within the FTA region to be sourced from a third-party country for use in qualifying textile and apparel products (USTR, 2017).

exporting country) in year t ; $TAUS_t$ refers to the average U.S. applied tariff rate for apparel (HS Chapter 61-62) in year t ; TPL_i and SSL_i are both dummy variables, which equal 1 when FTA i includes the TPL or the SSL mechanism and equal 0 when otherwise. We also include WH_i as a dummy variable in the model to see whether geographic proximity to the United States, i.e. located in the Western-Hemisphere ($WH_i = 1$), will result in more utilization of FTAs than otherwise ($WH_i = 0$). c_i is the constant and ε_{it} is the error term. Data for the study came from OTEXA (2017) and WTO (2017). Based on data availability, ten enacted U.S. FTAs³, and their utilization rate for apparel imports from 2005 through 2016 were estimated. Because the dataset includes both time series and cross-sectional data, panel data modeling technique and the generalized least square method (GLS) were adopted to tackle potential estimation problems such as serial correlation and cross-sectional heteroscedasticity.

Results and discussion:

Chi-squares of the Hausman test ($p=0.24>0.05$) suggest that at 95% confidence level, there is no unobserved sectoral effect correlated with other independent variables. Based on the result, we selected the random effect model (RE) to estimate Equation 1 because RE can generate more consistent estimation than fixed effect model (FE). For the RE model, P-value of the F-statistics were smaller than 0.01 at the 95% confidence level, suggesting that overall the dependent variable FTA_{it} has a strong correlation with independent variables. Specifically, results indicate that allowing SSL as an exception to the restrictive RoO in FTA ($H2$), increasing import tariff rate for textiles in the apparel exporting country ($H3$) and with geographic proximity to the United States will result in a higher U.S. FTA utilization rate for apparel imports. However, the results do not find the U.S. import tariff rate for apparel ($H1$) and the TPL mechanism have statistically significant impacts on the U.S. FTA utilization rate for apparel imports.

Implications and future research agenda: First, findings of the study suggest that U.S. FTA partners being able to use cheaper textile inputs from outside the FTA region through lowered import tariff rate for textiles could be one of the primary reasons why the utilization rate of U.S. FTAs for apparel imports has been falling. Second, findings of the study confirm that RoO is a critical factor affecting the use of U.S. FTAs. Loosening the restrictive yarn-forward RoO could encourage U.S. firms to use FTAs more often. However, it is unclear why the TPL mechanism did not result in a significant impact on the utilization of FTAs for apparel imports, which can be explored further in future studies.

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³ NAFTA, CAFTA, US-Colombia, US-Peru, US-Australia, US-South Korea, US-Morocco, US-Chile, US-Bahrain and US-Israel.

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